

Australian Taxation Office Staff
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Internal Audit – Looking Ahead

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particularly Mark Moloney**

1. Setting the Scene

My address this evening discusses some of the issues and pressures that we as auditors are likely to face as we go forward into the next millennium. I have no doubt that an important element of our role will continue to be assurance to the various stakeholders, including the Parliament, Government and agency management, which is increasingly related to how risk is managed. The audit function can add considerable value to the management of an organisation provided the audit is professional, timely and relevant and contributes to, but is not part of, decision-making.

There is increasing recognition of the positive outcomes that are possible from a partnering rather than confronting approach. The former requires mutual trust, understanding and recognition of the value of independent advice. This sounds contradictory and has to be managed well if the audit function is to be credible. On the other hand, complete detachment or divorce from management creates the risk of being irrelevant and ignored. The basic requirement is to understand the business/function we are auditing and the imperatives that are driving decision-makers as well as expectations of the various stakeholders.

Nowhere is the need for a completely focused, mutually supportive effort more apparent than in the Australian Taxation Office (ATO). The collection of taxes is fundamental to the Government's fiscal strategy and to its overall economic and social policies. It is our collective responsibility to assure the Parliament that no **unnecessary fiscal degradation** is occurring to this country's primary revenue base. But this is an ever-changing target as indicated, for example, by the increase in gross operating surplus of about \$5.5 billion per annum in The Australian Bureau of Statistics (ABS) estimates to take account of the understatement of income associated with the tax gap. This is indicative of the need to be prepared to take a proactive stance and ensure our strategies and structures are properly positioned to deal effectively with this situation.

There is no question that the environment facing us is a major determinant of the audit role in the future. It is what we do about that realisation that is important to the issues you are discussing in this conference. In my view the challenges are similar for both internal and external auditors. I will discuss these challenges in the context of the emerging public sector

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environment and the corporate governance framework which we are urging agencies to adopt. I will finish with some thoughts about outsourcing the internal audit function.

2. The Emerging Public Sector Environment

It is not my intention to canvass the wide-ranging reforms that have had a marked impact on the public service. However, there are some significant changes that are likely to affect both the audit function and the approaches we may need to take in our audit work. Change in itself will always require different strategies. Emerging issues are likely to be a major driver of such change. What we have learnt over many years is that focused and committed people handle the change process best. The ANAO has no doubt that the major challenge is to exhibit superior performance in a much more contestable environment. I suggest that you are confronted with the same imperative. Internal Audit does not have a legislated mandate and consequently is under even more pressure to demonstrate its value to an organisation.

The audit function is heavily linked into good agency management and governance. The greater flexibility provided to management under the various public sector reforms can both provide a more positive environment for audit to assist agency managers at all levels as well as place greater demands on that relationship with the requirement for at least commensurate management accountability. A greater emphasis on outcomes and less concern with due process may produce more cost effective results but may also increase the risk of control failures and inappropriate behaviour which in turn can impact adversely on the outcomes achieved as well as creating potential public embarrassment. From an Executive Government or Parliamentary viewpoint the latter may be regarded as much an outcome as the improvement the particular program was meant to achieve.

The issues of risk management and adequate controls are difficult for all concerned, not the least to achieve a realistic balance that is acceptable to all stakeholders. Positive comments in support of sensible risk management and decision-making have been made by the Chair (and Deputy Chair) of the Joint Committee of Public Accounts (JCPA) in recent months¹. This has been encouraging particularly in the face of continuing Parliamentary criticism in Legislation (Estimates) Committees examination of agency budget estimates and program performance. As clearly indicated in the MAB-MIAC guidelines², the requirement is to identify, prioritise and assess the various risks involved in program management and resource use and ensure adequate documentation of the basis of management decisions. I will say more about this later.

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The Government has accepted the basic principles set down by the National Commission of Audit³ for determining what activities should be undertaken within the public sector. As you know this has led to an increase in privatisation and outsourcing of government services and activities. But it has also meant that even traditional 'core' government services have become more contestable or have had to be more directly competitive with private sector providers. Undoubtedly, one of the most significant developments in public service reform has been the requirement to test the market with a view to determining the most efficient and effective method of service delivery.

Particular illustrations of this move towards a more private sector orientation have been in the areas of workplace relations, the provision of employment services, outsourcing of information technology, and accrual accounting and budgeting. All pose significant risks and challenges to managers and auditors. One example is the inevitable tensions between whole of government and organisation approaches that have to be managed positively and credibly. For managers, there is both a collective responsibility to ensure whole of government initiatives and requirements are implemented efficiently and effectively and an individual responsibility for the resources and outputs and outcomes required. Audit can assist in determining and implementing an appropriate accountability framework to assist in meeting and resolving any apparent contradictions in these responsibilities.

The reality is that this emerging situation may require different approaches to those that have traditionally been put in place and which have been developed over many years. Not surprisingly, managers have tended to rely on the underlying systems, both manual and electronic, with their built-in checks and balances and the associated administrative and other practices that have complemented them. What happens now with the adoption/adaption of private sector models and the actual involvement of the private sector in the processes of service delivery or in the actual delivery of the services themselves? The immediate issue has been the public service's ability to manage contracts for such performance effectively. Central to that challenge for both managers and auditors is the determination of appropriate controls and performance requirements under such contracts.

Other elements of the emerging public sector environment which will impact markedly on responsibilities of managers and auditors will be the replacement legislation⁴ for the *Audit Act 1901*, which I still hope will be passed in this session of Parliament to apply from 1 July next or soon after; the new *Public Service Act* which is expected to be introduced for passage later this year; whole of government financial reporting⁵ to apply to 1997-98 and beyond; the Charter of Budget Honesty⁶; and Service Delivery Charters⁷.

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The Public Service and Merit Protection Commission (PSMPC) and the Department of Industrial Relations (DIR) have recently produced a paper entitled *'Accountability in a Devolved Management Framework'*⁸ which sets out, in broad terms, a framework for a new Public Service Act. At another level, there is a requirement to address the MAB-MIAC Report on *'Achieving Cost Effective Personnel Services'*⁹ as a means of achieving efficiency gains in the APS. The PSMPC has recently issued a Guide¹⁰ to assist agencies address the people management component of any performance information review.

While we have a reasonable level of experience and skills to build on, the foregoing is a quite different environment to that which many public servants have had to deal with in their careers to date. As a result there is a considerable and probably demanding learning process which is likely to be involved. All stakeholders will be looking for levels of comfort and assurance that best practices are being followed and that the frameworks include at least due process, probity, fairness and ethical behaviour. Best results will come from a realistic partnership between management and audit to achieve robust outcomes in a timely fashion. Again I stress that it is not audit's responsibility to step into management's shoes but to take a strong advisory and review role which is oriented to prevention rather than cure.

In my view both internal and external auditors can do most to contribute to this emerging public sector environment by contributing positively and in a timely fashion to good corporate governance in agencies. In particular, internal audit should be both an integral part of corporate governance and assist in ensuring that it is properly implemented and operates efficiently. This is the major thrust of my address which I will now seek to explain within the context I have just outlined.

3. Contributing to Good Corporate Governance

The work that the ANAO has done with Government Business Enterprises (GBEs), particularly Telstra, and with the ATO in the last two years has clearly indicated the contribution that good corporate governance can make to an organisation's performance and to the confidence of its stakeholders. This work was a catalyst for the preparation of a discussion paper on *'Applying Principles and Practice of Corporate Governance to Budget Funded Agencies'*¹¹ by the ANAO. The final version of the paper, directed mainly at Chief Executive Officers, has just been completed.

Basically, corporate governance is about how agencies are directed and controlled. Many of the elements of good governance have been put in

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place by most agencies over the last decade, such as corporate and business planning, program management and budgeting, performance information and standards (targets); clear identification of stakeholders coupled with service charters or agreements, codes of conduct and, to a lesser extent, audit committees. The problem has been that they are not generally linked or interrelated in any way so that people in the agency understand both their overall purpose and the ways the various elements are linked to ensure a mutually supportive framework to produce identified outcomes for identified stakeholders. There is a clear leadership role to perform.

From the ANAO's observation, the ATO's governance framework has facilitated:

- achievement of corporate objectives;
- identification and management of risk (including determination of priorities);
- promotion of high ethical standards; and
- clarity of various management roles and accountabilities.

This framework should at least identify and gain acceptance for the emerging benchmarks for internal control and effective performance reporting. However, as I indicated earlier, assurance is increasingly related to risk management. David Macdonald, Controller and Auditor-General of New Zealand regards 'reduction in risk as the primary role for internal audit'¹². He also said that a secondary role may be 'to increase the operational payoff in any and all operation'¹³. The latter is clearly part of the partnering role with management and may be reflected not just in cost effective outputs and outcomes but also in their quality and in the confidence and trust of the agency's stakeholders.

Risk Management

It is generally accepted both in the private and public sectors that good corporate governance is an effective means of dealing with risk management. Auditors are generally well versed in applying risk-based techniques to their business. Public service managers are now addressing risk management as an important and integral element of their increased focus on outcomes as required by the Government's reforms.

An effective risk management process can ensure more effective delivery of public services, better resource allocation, higher standards of accountability, greater creativity and innovation in management practices

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and enhanced decision-making ability and cost effectiveness. However, it needs to be well integrated with other processes such as corporate and business operational planning and performance measurement and assessment if the corporate governance framework is to be credible and effective. As such, better risk management should provide improved capacity to manage in an environment of change with increasingly diverse and, in some case, competing obligations.

As I said earlier, the ATO is an important instrument of Government fiscal policy and the maintenance of a \$100 billion plus revenue base is fundamental to its success by whatever methods chosen to collect it. This factor provides a critical focus for management performance. Importantly, it is how the Commissioner provides assurance that the Commonwealth's exposure to revenue risk is minimised and managed that has allowed the **audit** process to provide to the Parliament a positive report on the financial stewardship of the ATO. The risk to revenue is arguably the principal component of risk facing the ATO.

I stress this aspect at the outset because it is the risk management strategy and its application that underpin the integrity of your financial statements. Your National Program Managers need to recognise this relationship. They 'own' the systems and procedures which are responsible for producing the financial statements. Effective action will avoid the likelihood of any qualification of the ATO financial statements and enhance the confidence level of all stakeholders in those statements with commensurate assurance that they fairly reflect the Office's financial outcomes. As well, the risk management process can result in better advice to government to enhance Budget forecasting and improve client service for taxpayers.

The recently completed performance audit on Risk Management in the ATO noted that the Office was among the first to introduce a formal risk management process as part of its strategic planning framework. The process known as the Health of the System Assessment (HOTSA) has been undertaken on an annual basis since 1994-95 across all Business and Service Lines (BSLs). The audit also commends the significant improvements to HOTSA introduced this year. Other agencies could learn valuable lessons from your experience leading to the latest initiatives.

Of further interest may be the use made by the ANAO of the MAB-MIAC risk management guidelines¹⁴ as a virtual benchmarking tool. This has been a very useful discipline that we have employed in other similar audits which not only generates good ideas but also provides a handy check-list of better practice which, as a by-product, can assist in the development of better agency-based processes for effective risk management.

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Against the above background Internal Audit will need to play a major participatory role facilitating an accountable risk management response such that the ATO's position is not exposed through, say, inadequate internal management processes. Internal Audit needs to provide high level assurance to the Commissioner that the risk to revenue has been minimised by ensuring internal controls are sufficiently robust to be relied upon to limit revenue exposures such as the tax gap referred to earlier.

Clearly there are other risk areas which have significant application in the ATO risk management context. For example, risks attaching to Asset and Liability Management (Information Technology (IT) and deferred tax losses) together with personnel issues should be high on the ATO's control agenda. It is worth mentioning that your biggest expense in the operating statement is employee costs which are in excess of \$1 billion. The latter involves a variety of risks, including to the perceptions of stakeholders within and outside the Office, which can impact markedly on the confidence, morale and credibility of the whole organisation.

The ANAO Audit Team has assured me that the effective monitoring of the revenue risk exposure is a matter of major audit significance within the ATO from year to year. The review of the risk management process consumes significant ANAO resources and is naturally also dependent upon a significant commitment from management and Internal Audit. We do want to make more use of internal audit work consistent with the auditing standard AUS 604 'Considering the work of Internal Auditing'. There is always scope for greater synergies between internal and external audit activities. We would wish to see a complementary approach on risk management strategy. As a result a much more efficient audit approach will be achieved.

The integration of audit effort contributes to a more robust control environment and greater confidence in financial reporting coupled with fewer adverse audit comments. Perhaps, more importantly, it should lead to a better performing environment. We should never lose sight of that imperative. The challenge to all parties is how do we add value to that outcome. At the very least we should be active in helping to create the environment where all the elements are focused on and supportive of real accountability, in a very personal sense, for what the agency does and how it does it.

Internal Accountability

The reform agenda requires defensible management processes which result in transparent accountability mechanisms. This is the direct responsibility of management including Internal Audit. Clearly identified control mechanisms, guidelines and review/monitoring procedures enhance

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the confidence a Chief Executive Officer (CEO) can have in the internal control and management of the organisation. Further, the planning and review of its operations and progress in meeting its corporate objectives, while fostering consultation and feedback on all organisation activities, can add to that confidence. The strategy for Internal Audit is to make itself indispensable. But it can only do so if it has broader management and analytical skills than just the traditional accounting qualifications, important though these may be in the current climate of reform.

Accountability structures for effective internal management of the ATO include management committees, audit and other operational committees set up for specific tasks. The **executive construct** in the ATO is impressive. It provides a sound and supportive management environment which gives the Office the best opportunity to achieve effective corporate governance. The scale of ATO operations has allowed a clear separation of duties and responsibilities between the Executive Board and National Program Managers. There is a close parallel here to the corporates in the private sector, for example in the demarcation between fiduciary duties and management's responsibilities for accountability to the Board. While there are clear differences between the public and private sectors, there are lessons to be learnt in the effective operation of Executive Boards in the public service as part of good corporate governance. The ANAO discussion paper referred to earlier deals in some depth with this issue.¹⁵

A key means by which accountability is exercised is increasingly through the use of information technology based management information or decision support systems. The systems will be fundamental to assessing the level of National Program Manager's performance. Of significance here is the growing importance of simplified access to integrated corporate data bases that allows considerable flexibility outside the control environment. Of course, corporate integrity needs to be protected by appropriate corporate controls. The available technology facilitates that outcome but it is often the need for management recognition of the vulnerability of the data base that is missing.

Information Technology (IT) is an issue of growing importance for all auditors. IT now often encompasses telecommunications as it is becoming even more difficult to make any sensible separation between the technologies involved. The challenge for the ATO is to harness IT resources so that a proper balance between efficiency and accountability can be maintained. The imperative for Internal Audit is to avail itself of the latest technology to obtain productivity gains which result in greater scope for diversification of its work - with emphasis on value adding to management. **I repeat that delivery on this fundamental should be a key element of your strategy.**

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The ANAO is now fully utilising computer based software for its Financial Statement Audits and Audit management as well as for a range of analytical techniques. Reflecting the increasing importance of desktop computing across the APS, the ANAO has been moving from Computer Assisted Audit Techniques (CAATS) on the mainframe to Personal Computers (PC) CAATS. The message I leave with you tonight is that we are very willing to share knowledge and expertise in these areas for our mutual advantage.

The IT operational framework has been broadly put in place but the agenda will require constant monitoring because this is the area where, currently, change is greatest. The ATO is faced with dynamic IT issues in an outsourcing environment (and the implications that go with that for the way in which it conducts its business) together with a management culture that will be asked to provide high level assurance about the systems and other controls to the Executive Board. Not the least of these problems will be the business issues associated, for example, with the year 2000 IT compliance requirements.

Executive management will be looking to the Internal Audit to help facilitate IT solutions and provide some assurance about the manner of their implementation and the attendant level of confidence provided. A similar observation could be made about the further major developments expected in the area of electronic commerce. A particular challenge which will impact on both internal and external audit is illustrated by the following situation that both sets of auditors may well be facing sooner rather than later.

Audit Reliance on Information Technology Based Controls

As part of the ANAO's risk based approach to financial statement auditing reliance may be placed on an agency's computer systems and the data they produce in order to form an overall opinion on the financial statements (Auditing Standard AUS 214 - Auditing in a CIS Environment). Where reliance is placed on Internal Audit activities in this area, a similar discipline prevails. The problem that is now emerging in a big way is how do we fulfil our obligations under the auditing standards where the agency's computing systems are outsourced, particularly in locations outside the agency.

At the preliminary planning phase of an audit an initial risk assessment is made as to whether it is probable, subject to testing, that the agency's computing systems are well controlled and managed and whether data produced from those systems can be relied upon for financial statement purposes. In short, the data has to be materially correct (refer to AUS 402 - Risk Assessment and Internal Controls and AUS 306 -Materiality). A decision that reliance will be placed on the agency's computer systems is a

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compliance based audit, meaning that testing of controls will be performed with minimal substantive testing, that is testing of individual transactions. In the ANAO and in the wider accounting profession such an audit approach is simply termed *reliance on controls*.

Where such reliance is placed on an agency's computing systems the following areas would in the normal course of events be subject to computer audit review on a three to five year cyclical basis:

general controls (such as logical security, change management, organisational controls, system software controls, communication networks and related systems controls and physical security);

application controls (security and systems controls built within the application); and

business resumption/disaster recovery planning.

The review and testing of the above areas are usually undertaken in the interim phase of the audit.

On completion of the audit testing the ANAO will prepare a draft discussion paper whereby audit findings, audit implications and risk exposures are brought to management's attention. The purpose of the discussion paper is to ensure the audit findings are factually correct and fairly stated. At this stage the ANAO seeks comments from management which provide for an agreed position as to the resolution of the audit findings. The final audit report in the form of an interim management letter is sent to the CEO of the agency. In the following audit cycle the ANAO will undertake a review as to the status of the previous year's audit findings. These practices are well known to Internal Auditors, perhaps much less so to management. The challenge is for all parties to manage a satisfactory outcome which continues to provide the necessary assurances for management and audit purposes without creating an unnecessary or counter-productive burden on any private sector provider. It would clearly be preferable if there is a recognition of the commonality of interests.

Financial Management

Separate but related to the above is the financial management framework in the ATO. You are moving towards having a clearly defined financial management framework providing a sound basis for high level assurance to the Commissioner that the ATO's resources are being managed efficiently, effectively and ethically. Your framework includes:

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- preparation of financial statements on an accrual basis - ensuring the accounts and records are maintained as required;
- establishment of an appropriate 'control environment' (including the HOTSAs processes);
- implementation of a fraud control plan;
- establishment of an effective Audit Committee; and
- support for a credible internal audit and evaluation capability.

Such a framework will not only require the full support of ATO managers at all levels but also strong oversight and assurance from the Audit Committee.

The Importance of an Audit Committee as part of Corporate Governance

I would like to reflect on the Audit Committee's role, particularly in the corporate governance context. It is another critical success factor for agency performance. The ATO Audit Committee recognises the contribution it can make to corporate governance. A difficult issue which needs to be considered, however, is how do public sector audit committees which generally consist of management only, that have separate assurance roles to the Executive Board for their line responsibilities, act or be seen to be acting independently in the Committee's monitoring role? Unlike the private sector, this demarcation issue in the public sector is unclear. Fundamental importance is attached to the independence of the 'Governing body' in the private sector and, in turn, to their Audit Committee. The relationship that Internal Audit has with the Audit Committee can assist to some extent in ensuring independence. But there are other arrangements that should also be considered.

As you are aware the replacement legislation for the *Audit Act 1901* requires agencies and entities to have Audit Committees. The ANAO is currently completing a Financial Control and Administration (FCA) audit into the use of Audit Committees. That audit will also produce a Better Practice Guide in the form of an Audit Committee Handbook. The Handbook makes the point that an effective committee has the potential to strengthen the control environment (of which it is a part) and assist the CEO and/or Executive Board to fulfil their stewardship, leadership and control responsibilities. Moreover, many of the benefits claimed are predicated on its independence and the objectivity this brings to its deliberations. In the final analysis the composition of an Audit Committee is a function of the governance model under which it operates.

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In a situation where an 'external' Board is accountable for an entity, it is entirely appropriate to have an Audit Committee comprised of a majority of members who are Audit also external to the entity, that is, not part of executive management. Audit Committee membership in such circumstances is drawn from the larger Board. However, where a governance model places sole responsibility and accountability with a single position, that is the CEO, an Audit Committee comprised of a majority of members from outside the organisation does not seem to confer the same benefits. The conundrum is to effect the appropriate balance between authority (and credibility) and independence.

I again reiterate that an effective audit function requires a good knowledge and understanding of the organisation's functions/business. Therefore it can be expected that an agency's Audit Committee will comprise at least some members from management. The clear imperative for them, which should be reinforced by the CEO, is that their membership is as informed and independent contributors not as representatives of their particular areas of responsibility. Complementing such membership, desirably, should be at least one 'external' representative who can provide skills, knowledge and perspectives that can both reinforce the independence of the Committee and enhance its deliberations and outcomes. I note that less than 30 per cent of agencies/entities currently have at least one external member on their Audit Committees.

In my view the CEO needs to specify clearly his or her assurance model as part of the corporate governance framework for guidance to the Audit Committee and to Internal Audit. I would expect that guidance would reinforce the authority and independence of both. That means the CEO does not need to chair the Committee and should not in my personal view. The possible exception to the latter is where the CEO might wish to give a clear message to the agency at the outset of the importance of the Audit Committee and its role in corporate governance and the necessary 'stamp of authority'. The CEO should then step aside once there is confidence this has been achieved.

I now turn to the accruals issue.

Managing on an Accrual Accounting and Budgeting Basis

Quite different financial management requirements will flow from the provision of accrual-based accounting. The following timetable has been announced by the Minister for Finance:

providing audited consolidated financial statements of the Commonwealth for 1996-97;

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trial of accrual budgeting for selected agencies 1998-99; and implementing full accrual framework, including an accrual-based budget and quarterly accrual reports from 1999-2000.

Much has been said of the relevance and usefulness of accrual accounting to APS managers. The immediate imperative is to ensure management is able to move effectively from a cash-based to an accrual-based system. The introduction of accrual budgeting will make this capacity even more critical. The main issues are likely to be about awareness raising (and education) and both financial management and user friendly decision support systems. The APS is increasingly being required to account for its performance with the greater emphasis on outputs, from a budgetary perspective, and particularly on achieving program outcomes. Managers will need to rethink their approach to management using accrual based systems, including the nature, volume and scope of performance information necessary for management purposes. For many, this may also involve the consideration of activity based costing systems to assist in meaningful measurement of program input and outputs and their respective outcomes.

The importance of reliable financial information at a Whole of Government accounting and budgeting level will become even more apparent with a focus on the Government's performance in a more integrated business sense in terms of, say, assets, liabilities and inter-generational equity issues. The Charter of Budget Honesty will reinforce this focus with the requirement for articulation of the fiscal strategy leading to greater public awareness of the Government's objectives and establishing a benchmark for evaluating fiscal performance. In the Treasurer's words:

'Transparency and accountability of government will be substantially increased through improved disclosure of fiscal policy intentions and the regular reporting of information on fiscal developments.'¹⁶

The ANAO is well aware of the pressures that the move to accrual accounting and budgeting will involve for agencies both at an organisation and whole of government levels. We recognise that it is primarily a problem for management in the first instance but it does involve concepts, principles and practices that auditors are familiar with. Consequently there are opportunities for important advisory and assuring roles for the latter to play. You will note I fall short of referring to any consultancy role. In particular we are willing to participate with management and Audit to ensure that the ATO's underlying financial management and related control systems are robust enough to support and lend credibility to the financial statements in particular and to your budgeting and reporting in general.

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Having identified the broad financial management imperatives it is well worth recounting what should be the ATO's executives' expectations. Again I stress the fundamentals; high level assurance (upwards from management to the Executive Board) independently monitored by Internal Audit and externally validated by the ANAO. The result hopefully is a credible accounting representation of the financial management and performance of the ATO.

All this assurance and monitoring from management, internal and external audit raises the question of how you can get the best leverage and maximum advantage from the range of these activities? Perhaps one could suggest that this issue could be a catalyst for Internal Audit to review its past coverage and assess its relevance in meeting the Commissioner's strategic directions which must be subject to frequent review in a constantly changing environment. As I have indicated, it is essential for Internal Audit to become proactive and assist in the development of effective management approaches. The same imperative would also apply to management, for example in transferring talented people to Internal Audit - as I understand the ATO has done over many years. A two way interchange process would continue to contribute to the maturity of the ATO financial management culture.

Code of Conduct

The evolving reform environment in Australia over the last twelve years or so is being reflected in the replacement legislation for the *Audit Act 1901* and the *Public Service Act*. The new Acts will indicate the significant change in the manner in which the business of government is conducted by the APS. The proposed legislation will serve and reinforce the fundamental values espoused by the APS, that is, integrity, honesty and impartiality. These values have been already enunciated in the MAB-MIAC Report on 'Ethical Standards and Values in the Australian Public Service'¹⁷ and, more recently, in the proposed framework for a new Public Service Act prepared jointly by the Public Service and Merit Protection Commission (PSMPC) and the Department of Industrial Relations (DIR).¹⁸

A clear set of values supported by a code of ethical conduct provides a sound basis for assurance to the CEO that there is consistent ethical behaviour at all levels of the agency and by its individual employees. A culture of ethical behaviour is particularly important in the APS because of the discretion inevitably involved in the development and implementation of public policy. The Public Service Act framework document, just referred to, proposes that a Code of Conduct be included in that Act. While such a code would be useful, as indicated by the list of requirements¹⁹ in the document, it would also be legally enforceable. However, by their general nature, the wide-ranging requirements are unlikely to reflect the particular

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circumstances of many agencies. For this reason the ANAO is in the process of developing its own Code within whatever constitutes the APS standards. Auditors must have a sound appreciation of the purposes and requirements of any agency code and the capacity to help ensure its effectiveness. The code will be central to any corporate governance framework.

Your Commissioner has embraced the ethical standards that have been promulgated and has provided a suitable framework for the ATO. As I understand, there is an expectation that ATO staff conduct themselves in an exemplary fashion, that is, by being:

- open, accountable and professional;
- identifying and managing issues as they occur;
- offering client focussed solutions;
- having integrity; and
- being fair and professional in dealing with each other.

What is more difficult is not only delivering on these standards but also having confidence that they are accepted, understood and applied by all staff as an integral part of their corporate approach. Prevention is always better than cure. I would therefore expect Internal Audit to take a high profile in maintaining the emphasis that has been placed on ethical behaviour as part of good corporate governance.

Client Service Orientation

One area in which we can learn from the private sector is in being aware of the prime necessity of providing a quality service to clients (or to our various stakeholders). This focus is a practical necessity in the private sector. Previously, it has not necessarily been recognised as being quite so important in the public sector. There are no doubt still many areas in the public sector where such a notion is considered inappropriate and may *indeed* be. Some argue that is because the service recipients do not really have the same types of choice. It is certainly true that, in the past, they had limited choice about where they had to go to get services and what they actually got or were actually entitled to.

We know that listening to and focussing on the needs of clients or customers involve similar disciplines and skills to those of the private sector. The approach taken is more an attitude of mind than simply a vehicle for marketing products. Nevertheless we cannot ignore our particular responsibilities to the Government and to the Parliament nor,

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indeed, to the rights and obligations of our clients as citizens. Management's problem is how to achieve the right balance particularly in areas which traditionally have been regarded as 'core' government.

It is not surprising that, for many public sector agencies, a culture of client service is still developing. This culture is something that we in the ANAO are learning to understand as part of better practice, particularly in identifying where and how separation can be made between members of the public as client and citizen. The Office itself has been trying hard for some time to work more closely and supportively with agency staff and managers on such issues. Many Internal Audit units have been doing likewise.

While few of us really like criticism, there is general acceptance that constructive reports can help us do our job better and that recognition of good performance can both reinforce and lift the confidence and morale of those involved. As part of this service orientation, we have increased the range of our 'products' which, we consider, will assist agencies and the Parliament. I will briefly outline the purpose of two of these and their relationship to Internal Audit and its functions.

Audits of Financial Control and Administration (FCA) are concerned with improving the quality of public sector administration by assessing systems of internal control, elements of the accountability framework, risk management strategies and legislative and procedural compliance. These audits aim to encourage agencies to achieve better practice in selected areas. It is a good example of being proactive rather than reactive or encouraging rather than being critical. Reports are provided to the CEOs of the agencies involved, normally 15 to 20, to indicate how their particular organisation rates against the identified better practice. The report to the Parliament is generic and refers only to a named agency where it reflects aspects of better practice. As part of an agreement with the Joint Parliamentary Committee of Public Accounts we will be reviewing how well agencies rate against the better practice in subsequent audits and reporting accordingly to the Parliament.

It would be expected that Internal Audit would, as a matter of course, follow-up agency management's action in relation to the better practice identified in FCA audits and, if necessary, encourage management to do so preferably in the interests of better performance but at least because of the likelihood of subsequent external audit review. In my view, it is not Internal Audit's function to undertake an examination of the agency's practices unless specifically requested by the Audit Committee. It would be preferable for Internal Audit to review management action taken in relation to their examination of agency processes as against the better practice identified in particular FCA reports.

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The results of our experience, particularly in the FCA area are very positive. For example, the asset management audit was the first FCA to be reported. It found that asset management was handled reasonably well at an operational level but there was a pressing need for a more strategic approach. A better practice guide and handbook was issued which dealt with the practical implementation of an integrated asset strategy. Both were well received by agencies and by asset management professionals. The interest in the handbook has extended into academia and the private sector, including from overseas.

The payment of accounts audit also identified a gap between current and best practice in this area. The better practice guide and handbook give a very good insight into the likely direction and future trends in this area. As with recent developments in procurement this is very much predicated on strategic alliances or partnerships with key suppliers. While this is a particular concern for management there is a need to ensure that, where necessary, there are robust systems controls backing up such arrangements sufficient to provide confidence to all parties and to minimise any risks.

Assurance and Control Assessment Audits (ACAs) are aimed at providing Parliament and agencies with an assessment of the level of key controls being applied within common or core administrative activities of a corporate nature for example personnel payments, travel and procurement. This is an area where we would expect not only to be able to rely on the work of Internal Audit but also to provide support for it. Again, our reporting to Parliament will be generic not agency based and will be at least included in the annual audit report on the results of the financial statements of Commonwealth Entities. Agency assessments will be included in the Management letters. The audits are designed to inform the Parliament and CEOs about fundamental housekeeping issues on administrative accountability. In large part they should alleviate many of the concerns being expressed about the adequacy of controls in an environment of devolved authority and provision of services externally to the agency.

In such an environment the question also has to be asked of Internal Audit as to what they think is required of them by their clients and whether they have considered the relevance and usefulness of their product profile. You will almost certainly need a range of products to facilitate the management process. The National Program Managers have to provide a level of assurance to the Executive Board and to the Commissioner. Your monitoring role and the type of products you can deliver can contribute greatly to their capacity to meet their obligations. **Again your strategy is pivotal here.** You have to maintain a sensible balance between your financial compliance and discretionary work to meet the Commissioner's changing stewardship obligations. You will need to focus on improved

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services as an integral part of product delivery to be valued and recognised as a real partner with management.

From a performance viewpoint you need to be able to benchmark your activities. This requires not only a clear identification and evaluation of your business process but also the ability to cost your work in an efficient and effective manner. In other words you will need to reflect an industry standard both in terms of delivery and cost. In short, your success in Client Service will ultimately determine your role or even your survival. The very real risk arising from under or non achievement of this imperative could be management examination of other options that can actually deliver. This leads me to the issue of possible outsourcing of the internal audit function which a number of agencies have now done.

4. Outsourcing Internal Audit Services

Most public servants are familiar with contestability of ideas and views in their bids for resources. In March 1996 Gary Sturgess, in speaking about the 'Changing Face of Government' noted that contracting-out is not a new phenomenon for the public service²⁰. However, as he also pointed out, a major difference is that 'we are now contemplating competition in the central functions of government'²¹. The aim of introducing new service delivery arrangements is to improve efficiency and effectiveness. This should be regarded as a discipline as well as an opportunity. The challenge is to be part of the changes that are occurring and not simply be a spectator.

The Department of Finance's definition of contestability for the APS is: *'the prospect of competition in public sector activities to improve both program efficiency and effectiveness.'*²² Consideration of contestability and competition brings into question issues of 'competitive neutrality' or the so-called 'level playing field'. In practice these conditions are not capable of being implemented effectively or credibly in the current environment facing agency managers. Nevertheless, all Australian Governments have made a commitment to 'competitive neutrality between government and private business activities' in the Competition Principles Agreement (CPA) executed at the Council of Australian Government's (COAG) meeting in April 1995. Competitive neutrality requires that: 'where governments choose to provide services through market based mechanisms that allow actual or potential competition from a private sector provider, that competition should be fair.'²³ That sentiment, simply put, is unarguable. The 'devil' is in the implementation.

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The Department of Finance has released guidance for managers on competitive tendering and contracting.²⁴ The guidance indicates that key elements of competitive neutrality include:

the tender process does not give an unfair advantage to either in-house or external tenderers;

organisational structures ensure visible and auditable accountability arrangements; and

financial comparisons reflect full cost attribution, including taxation or a tax-equivalent regime, return on capital and overheads (including where these are notional costs to the in-house bidder).²⁵

Finance suggests that a decision to allow an in-house bid should be made on a case-by-case basis. Staff issues also need to be handled sensitively while ensuring the process is fair and equitable. Guidance on the people aspects of outsourcing is provided in the PSMPC's publication 'Outsourcing: Human Resource Management - Principles, Guidelines and Good Practice'²⁶. The Guidance also notes that a complaint mechanism, administered by the Productivity Commission, will come into effect from July 1997 to respond to complaints relating to Commonwealth organisations not complying with competitive neutrality.

Most criticism about competitive neutrality usually comes from the private sector, which tends to be more about factors endemic to public administration and over which public service managers have had very little, if any, control. Fortunately, as discussed earlier, this situation is changing, albeit slowly. In my view, the most inhibiting factors for public sector managers are the constraints on funding and the ability to determine the nature and extent of business being conducted and thereby being able to maximise opportunities for success and minimise costs. Fairness has to be a two-way street. But, at the end of the day, the Australian public is entitled to receive value for money from its taxes and charges for government services regardless of how, or who, delivers them.

From my observation there is a temptation for auditors and evaluators to regard themselves as somehow standing outside, unaffected by, the environment within which they work, instead of being part of it. This in no way implies a lessening of the importance of their independence. For Internal Audit to have a meaningful future in the years beyond 2000 it must be a vital and endemic element of the environment within which it works. Market testing and outsourcing, as elements of competitive neutrality, are now an integral part of that environment. The challenge will be to contribute proactively rather than just reacting to changing events. The aim should be to ensure we are part of the solution.

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From an ATO Internal Audit viewpoint, you need to have a comprehensive strategy that complements and supports the Commissioner's planned actions to consolidate the Government's fiscal direction. This clearly has implications for you as audit practitioners. Auditors, among other attributes, have to be very good at diagnostics and analysis. They have to be able to spot financial strengths and weaknesses and anticipate control and other accountability problems downstream which differentiates them in a professional sense from most other staff. The old saying 'the best way to predict the future is to create the future' is highly relevant to your situation.

From an external audit point of view, outsourcing of Internal Audit is viewed as another means of service delivery. In short, the ANAO neither supports or opposes outsourcing of the function per se. In essence, the decision depends very much on just what kind of internal audit services management requires. I am particularly sympathetic to the situation confronting management in determining viable arrangements in small agencies. There is clearly a 'critical mass' problem which impacts adversely on the recruitment and retention of the requisite professional skills.

Any decision by management on outsourcing should be made on a realistic assessment of value for money given the risks and responsibilities involved. This assessment will vary with the circumstances of each agency and the trade-offs individual managements are prepared to consider, particularly in their control environments and within the broader accountability responsibilities to the Parliament. It is important that such assessments are made within the ambit of their corporate governance arrangements so that the full implications are reviewed but not in any partial sense where the consequences are only discovered later in some accountability failure, impacting adversely on the whole agency.

An interesting observation was made in an audit conducted by the New South Wales Auditor-General late last year:

'Any economies of scale through shared audit management were felt to be less important than a close and unambiguous relationship with one Board and one management team'.²⁷

There are potential advantages and pitfalls in any outsourcing arrangement. One observation I would make is that the key to any outsourcing arrangement is the need to retain the capacity to manage effectively the service provider. It should not just be assumed the service will be provided as agreed. There needs to be a suitable level of monitoring and review to ensure this is in fact the case. I would also be concerned that, complementary to that capacity to monitor and review, there is recognition of the need to develop an appropriate internal audit

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strategy complementary to the overall corporate strategy and governance framework. This requires a very good understanding and appreciation of the business functions of the agency and close liaison with its managers and external audit.

ANAO auditors have noted a tendency to outsource only the internal audit activities associated with financial reporting. This may be extended to audit of internal systems in some cases. The remainder, however, does not automatically default to the external auditor. This potential gap is currently exercising our minds for discussion with relevant agency Audit Committees. As an indication, in many instances the internal audit issues that should be of concern to managers are not 'material' to our financial statement audits of individual entities. Unthinking dependence on external audit does not seem to be very good risk management in such circumstances.

5. Summary Comments

It is axiomatic that, in considering our future and the strategies necessary to secure it, the environment in which we operate will largely dictate the nature and scope of what we can do. Nevertheless we also need to be proactive in these latter respects if we are not simply to accept whatever decisions are made by others that determine what our future might be. A useful tactic is to endeavour to influence such decisions and even the framework in which they are taken. For Internal Audit, I suggest the consequent focus should be basically on management and corporate governance respectively.

Auditors do have skills that are in demand. Increasingly these go beyond accounting qualifications and experience important through they undoubtedly are in the present and likely future APS climate. While it is likely that Internal Auditors will require more management oriented, advisory and performance assessment skills in the future, particularly in large agencies such as the ATO, there will be a premium on accrual accounting and budgeting oriented knowledge in relation to financial management. This reflects the lack of such intelligence generally in the APS that has been oriented almost solely to a cash-based system and has virtually no background in activity-based costing systems. I stress that I am not advocating a consultancy role per se for internal, or for that matter external, audit but I do see a premium being placed on independent guidance and assurance about associated systems and financial reporting. This is both a test of professionalism and creativity.

The emerging public service environment involves risk elements in the change processes and in the external as well as the internal delivery of

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services based on a more contestable, if not competitive, environment. I agree with the New Zealand Auditor-General that taking an active role to allow organisations to reduce risk is likely to be the biggest challenge for Internal Audit for the foreseeable future. There needs to be a good understanding of the various elements of that new environment as well as how they will impact on decisions taken by agency management in adjusting to, and hopefully in the innovative development of, a more outcomes based management approach in accordance with government policy.

More outsourcing and private sector provision of public services, as part of the implementation of competitive neutrality, will place greater pressure on contract management and performance assessment of service providers. In themselves, these pose risks for public service accountability that are much broader than financial probity and adequate monitoring and reporting. Moreover, there are likely systems control issues, particularly related to computing environments located outside the agency, which could adversely impact on the level of assurance that can be provided to management as well as on the preparation of agency financial statements and the external audit opinion.

The challenge for Internal Audit in the period ahead is to make itself indispensable to agency management. While it is important to maintain audit independence, it should be possible to forge a partnership arrangement that focuses on issues of greatest risk to management in their accountability relationships with the agency's various stakeholders. Such a partnership should also extend, in a complementary fashion, to external audit and the services it provides. For example, the Better Practice Guides provide a target or benchmark of performance on a range of resource management issues. Basic control assessment and probity audits offer a similar opportunity both to indicate clearly to management the value of the Internal Audit function and to make improvements in the agency's accountability regime. Internal Audit can therefore be a source and user of such analyses not only to add value to the management performance of the agency but also to the public sector as a whole.

The mutual partnership between management and audit has a forum in the Audit Committee. The latter is integral to good corporate governance particularly in the areas of ethical behaviour, probity, fraud control, risk management, systems controls, financial management budgeting and reporting, use of accrual-based information and overall assurance. The Committee is both mentor and touchstone for Internal Audit. It will endorse the latter's strategic and operational plans. With the CEO, the Committee will also have the responsibility to ensure their effective implementation. But it is not necessary to create a combative situation. To the contrary, Internal Audit should endeavour to work with management at all levels in the common pursuit of better performance. Tensions will undoubtedly occur from time to time but will quickly disappear if Internal Audit has management's confidence. This has to be earned.

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In my view auditors will win stakeholder confidence and trust by acting as if their activities are contestable. I have referred to the need for high levels of audit professionalism and quality work including quality client service orientation. Suitable benchmarking of performance and peer reviews are key elements in creating and maintaining credibility with management. In the ANAO's situation, we have to 'earn' our mandate. In yours, you have to win it. This will only occur if you are part of the solutions for dealing with the changing environment. Therefore you should aim to create the future rather than simply to be its observer. Management has to be convinced such involvement is in its interests. That will only occur if you perform well. And that is the challenge for all of us in the years ahead.

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NOTES AND REFERENCES

1. Somlyay Alex M.P., 1996 *'Keynote Address to the 1996 Public Sector Accounting Convention'*, Canberra, 14 November (page 5).
2. MAB-MIAC 1996. *'Guidelines for Managing Risk in the Australian Public Service'*, Report No.22. AGPS Canberra, October. (pages 19 and 20).
3. National Commission of Audit 1996. *'Report to the Commonwealth Government'*. AGPS, Canberra, June (see particularly pages vii and 10 to 12).
4. The *Audit Act 1901* is intended to be replaced by the following Acts:
 - *Auditor-General Act (AG)* which will provide for the appointment, independence, status, powers and responsibilities of the Auditor-General; the establishment of the ANAO and for the audit of the ANAO by an Independent Auditor. Together with the following two Acts, it will provide the mandate for the Auditor-General to be the external Auditor of all Commonwealth-controlled bodies;
 - *Financial Management and Accountability Act (FMA)* which will set down the financial regulatory/accountability/accounting (accrual-based) framework for Commonwealth bodies that have no separate legal criteria of their own; they are, financially simply agents of the legal entity, that is the Commonwealth;
 - *Commonwealth Authorities and Companies Act* which will provide standardised accountability, ethical and reporting provisions for Commonwealth bodies that have a separate legal existence of their own (even though they may derive some or all of their finances from the Commonwealth Budget). Such bodies comprise Commonwealth controlled companies and their subsidiaries and those statutory authorities whose enabling legislation gives them legal power to own money and other assets.
5. The second Trial and Unaudited Whole of Government Financial Statements (relating to the year ended 30 June 1996) will shortly be released by the Minister for Finance. There is a shared commitment to providing quality, unqualified results for the audited statements for 1996-97. Only about 30 agencies, including ATO, have a material impact on the overall results and will therefore be subject to additional work in preparing the Whole of Government Financial Statements.

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6. A Charter of Budget Honesty was an election promise of the current Government. A Bill of the same title was introduced into the House of Representatives by the Treasurer on 11 December 1996. In short, the Charter is concerned with two objectives; first, the enhancement of fiscal reporting and, second to require the Government to observe certain principles of sound fiscal management. The principles will take account of the need to address short-term issues, such as cyclical economic downturns, while recognising the importance of medium-term issues such as the sustainability of Government debt and national saving. The Bill also included many of the recommendations of the National Commission of Audit's June 1996 Report (pages xxii and xxiii) and of the Joint Committee of Public Accounts (JCPA) (Report 341 of November 1995). However, the Senate referred the Bill again to the JCPA on 3 March 1997. The Committee's report was tabled in the Senate on 20 March (Report 351). The JCPA said it was pleased that the fiscal reports being legislated in the Bill provide an approximation of Whole of Government reporting but suggested there should be a subsequent review of the whole reporting cycle by the Auditor-General. Interestingly, the Committee also said that:

‘the Public Sector Accounting Standards Board should establish prospective reporting standards for the economic and fiscal outlook and intergenerational reports since the requirements for these reports may differ from the Government Finance Statistics Australia Standards being recommended in the Bill’ (page 20)

7. The commitment to introduce Service Charters which would include a set of performance criteria for Government departments, agencies and utilities was announced in the Coalition Parties' Consumer Affairs policy entitled 'The Consumer Interest' dated February 1996. Of interest, is that there was a commitment for a Coalition Government to:

‘legislate (my underlining) to entrench the Australian Taxation Office Taxpayers' Charter to guarantee fair treatment of taxpayers’ (page 2).

As implied, there were Service Charters being contemplated or actually in place at the time which had borrowed on the United Kingdom's Citizens' Charter. As noted in the Discussion Paper 'Towards a Best Practice Australian Public Service' issued by the Minister for Industrial Relations and Minister Assisting the Prime

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Minister, the Hon. Peter Reith M.P., AGPS, Canberra November 1996:

'They (Government Service Charters) represent a valuable addition to the public sector reform agenda.'

Quoted in Canberra Bulletin of Public Administration No.83 February 1997 (page 1). A booklet 'Putting Service First - Principles for Developing a Service Charter' was launched by the Minister for Small Business and Consumer Affairs on 27 March 1997. These Principles are also available on the Internet address: <http://www.dist.gov.au/consumer/charters>. From July 1997 all government bodies which provide services to the public will be required to develop individual charters. The Minister in the Foreword to the booklet indicates that:

'Service Charters will be a powerful tool for management, staff and customers to continuously improve services. The result should be a more accountable and responsive public service' (page iii).

8. Public Service and Merit Protection Commission (PSMPC) and Department of Industrial Relations (DIR) 1997 *'The Public Service Act 1997 - Accountability in a Devolved Management Framework'*, AGPS, Canberra May.

Of interest is the following comment:

'For the first time the Act will provide a model of accountability in which the public interest is clearly articulated.' (page 4)

The paper also sets out the 'Key powers and responsibilities of Secretaries in the devolved APS' (see page 5). Perhaps of particular note in the context of this address is the proposed requirement for the Public Service Commissioner to audit the maintenance of public service standards; have extensive powers to undertake reviews or investigations of employment policies and practices; and present to Parliament an Annual Report on the state of the APS (page 6).

9. MAB-MIAC 1995 *'Achieving Cost Effective Personnel Services'*, Report No.18, AGPS, Canberra.

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10. Public Service and Merit Protection Commission (PSMPC) 1997. *'Performance Information Review - Human Resource Management'*, Canberra, May.
11. ANAO 1997 *'Applying Principles and Practice of Corporate Governance to Budget Funded Agencies'*, Canberra, June.
12. D.J.D. Macdonald 1996. *'The Role of the Auditor in the Proactive Dissemination of Information'*. Address to the Institute of Internal Auditors. 10th Anniversary Conference. Office of the Controller and Auditor-General, Wellington, New Zealand, 16 September (page 2).
13. Ibid., (page 2). David Macdonald also notes that 'the auditor should stay as removed from day-to-day operations as possible' (page 6).
14. MAB-MIAC 1996. *'Guidelines for Managing Risk in the Australian Public Service'*, Report No.22. AGPS, Canberra, October.
15. Op.cit., ANAO *'Applying Principles and Practice of Corporate Governance to Budget Funded Agencies'* (see section entitled Principles for a Public Sector Executive Board).
16. Costello Peter, The Hon. 1996. *'Charter of Budget Honesty Bill 1996 - Second Reading'*, Parliamentary Debates. House of Representatives, Hansard, 11 December (page 8183).
17. MAB-MIAC 1996 *'Ethical Standards and Values in the Australian Public Service'*, Report No.19. AGPS, Canberra, May (see particularly pages 8 and 9).
18. Op.cit., PSMPC and DIR *'The Public Service Act 1997'* (page 11).
19. Ibid., (pages 14 and 15).
20. Sturgess, Gary 1996. *'The Changing Face of Government: Producer? Agent?'*. An address to a Lunchtime Seminar hosted by the Resource Management Improvement Branch, Department of Finance. Canberra, 21 March (page 1).
21. Ibid., (page 26).

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22. Department of Finance 1995 *'Examining Contestability within the APS : Initial Information'*. Management Improvement Discussion Paper No.3. Resource Management Improvement Branch. Canberra, November (pages 1 and 2).
23. Department of the Treasury 1996. *'Commonwealth Competitive Neutrality - Policy Statement'*. Market Structure Section. Canberra, June (page 3).
24. Department of Finance 1997. *'Competitive Tendering and Contracting - Guidance for Managers'* (An Exposure Draft). Performance Improvement Group, Canberra, May.
25. Ibid., (page 10).
26. Public Service and Merit Protection Commission 1996. *'Outsourcing : Human Resource Management - Principles, Guidelines and Good Practice'*. AGPS, Canberra, September.
27. The Audit Office of New South Wales 1996. *'Accountability and Internal Review Arrangements at State Rail'*. Performance Audit Report, Sydney, December (page 23).