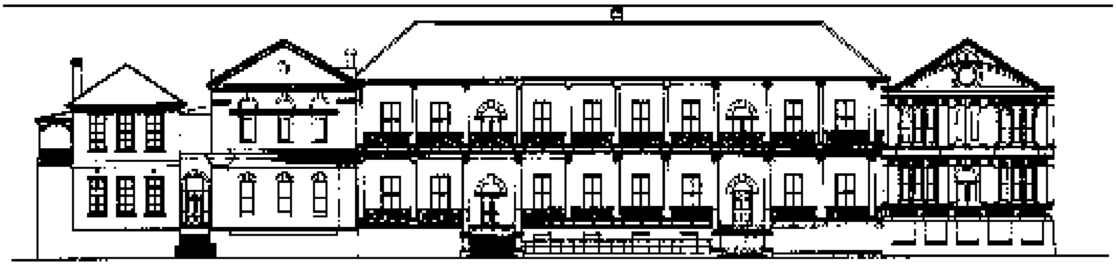
PUBLIC ACCOUNTS COMMITTEE

Review of Reporting Requirements for Small Agencies

Discussion Paper



Report No. 138 **November 2002**

[No. 20/52]

This report was compiled using *Word 97*

and printed by the Parliamentary Printing Services.

This report will be available on the Internet via*:*

http//www.parliament.nsw.gov.au

New South Wales Parliamentary Library cataloguing-in-publication data:

New South Wales. Parliament. Public Accounts Committee

Review of reporting requirements for small agencies / Public Accounts Committee. [Sydney, N.S.W.] : The Committee, 2002. – ii, 9 p. ; 30 cm. (Report no. 138 / Public Accounts Committee) ([Parliamentary paper] ; no. 20/52)

At head of title: Parliament, NSW.

“November 2002”.

Chair: Joseph Tripodi.

ISBN 07347 6619X

1. New South Wales. Public Finance and Audit Act 1983
2. Finance, Public—New South Wales—Auditing.

I. Tripodi, Joseph.

II. Title

III. Series: New South Wales. Parliament. Public Accounts Committee. Report ; no. 138

IV. Series: Parliamentary paper (New South Wales. Parliament) ; no. 52/20

DDC 657.835

Charter of the Committee

The Public Accounts Committee has responsibilities under the *Public Finance and Audit Act 1983* to inquire into and report on activities of government that are reported in the Total State Sector Accounts and the accounts of the State's authorities.[1] The Committee, which was established in 1902, scrutinises the actions of the Executive Branch of Government on behalf of the Legislative Assembly.

The Committee recommends improvements to the efficiency and effectiveness of government activities. The sources of inquiries are the Auditor-General's reports to Parliament, referrals from Ministers and references initiated by the Committee. Evidence is primarily gathered through public hearings and submissions. As the Committee is an extension of the Legislative Assembly its proceedings and reports are subject to Parliamentary privilege.

Members of the Committee

The Committee comprises members of the Legislative Assembly and assumes a bi-partisan approach in carrying out its duties.

Chairman:	Joseph Tripodi MP, Member for Fairfield
Vice-Chairman:	Pam Allan MP, Member for Wentworthville
Members:	Ian Glachan MP, Member for Albury
	Katrina Hodgkinson MP, Member for Burrinjuck
	Richard Torbay MP, Member for Northern Tablelands
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[1] See Part 4 of the Act – The Public Accounts Committee.

Chairman’s Foreword

The Public Accounts Committee has resolved to inquire into the efficiency and effectiveness of accountability arrangements for small agencies. This inquiry was prompted by a recommendation from a review of the Audit Office which identified the cost of auditing small agencies as a potential source of inefficiency.

The Committee considers it of vital importance for Parliament to have assurance of the sound financial management of public funds through financial reporting and auditing. However, in the case of agencies with small budgets engaged in low risk activities, there may be a need to balance accountability against the sometimes burdensome cost of report preparation and audit services.

There are economies of scale for financial reporting and auditing. For instance, as part of auditing agencies’ accounts, the auditor must be assured that the accounts are materially correct. For smaller agencies, this can mean spending a great deal of time addressing issues which would not be material to larger agencies or the State accounts as a whole.

This inquiry will examine taking a risk management approach to financial reporting issues. This is consistent with other Government practices such as the move to table the Total State Sector Accounts earlier in the year. The Audit Office responded to this development by allocating priorities based on the materiality of agencies to the entire Budget.

The Committee notes that this inquiry may assist the Treasurer in the ongoing fundamental review of financial management legislation. It may also inform discussion for the forthcoming review of differential reporting planned by the International Accounting Standards Board.

In conducting this inquiry, the Committee will consult widely with all interested groups and agencies.

As a first step, the Committee has prepared this Discussion Paper. It canvasses issues relating to the efficiency and effectiveness of reporting arrangements and asks a number of questions in order to stimulate public debate.

I invite submissions to this inquiry from all parties interested in public sector financial management.

Joe Tripodi

Joseph Tripodi MP
Chairman

Effectiveness and Efficiency of Reporting Requirements for Small Agencies

The Public Accounts Committee has resolved to investigate the effectiveness and efficiency of the current reporting requirements for those small agencies required by the *Public Finance and Audit Act 1983* (the Act) to prepare financial statements for audit by the Auditor-General.

The Committee is also investigating the suitability of linking financial reporting and the requirements to prepare annual reports under the relevant Annual Report Acts for Departments and Statutory Bodies.

Background

Section 48A of the Act provides for triennial comprehensive reviews of the Audit Office. The 2000 Review commented that the mandatory auditing of very small agencies could be a source of inefficiency and the costs of the audit could be a financial burden. Recommendation 13 of the Review stated:

> The Auditor-General should discuss with Treasury alternative proposals for auditing small clients.[2]

The Committee understands that the Auditor Office and Treasury have discussed this issue but considered reporting requirements were more appropriately determined by Parliament, which represented the interests of the public users of this information.[3]

On this basis, the Committee resolved to investigate the matter of reporting requirements with a view to bringing any feasible improvements to the attention of Parliament.[4]

This discussion paper has been prepared as a first stage of the inquiry in order to inform public debate of these issues.

Legislative requirements

All bodies listed in Schedules 2 and 3 to the Act are required to prepare annual financial statements in accordance with the Act, public sector requirements and the Australian Accounting Standards for audit by the Auditor-General. Schedule 2 consists of a list of statutory bodies and Schedule 3 is a list of departments. The definitions of “statutory body” and “department” extend to entities controlled by

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[2] Public Accounts Committee *Review of the Audit Office of New South Wales under section 48A of the Public Finance and Audit Act 1983*, Report No 2/52, 120, NSW Parliament, Sydney, 2000, p 22

[3] Discussion between Secretariat and Deputy Auditor-General, 28 August 2002

[4] Minutes of the Public Accounts Committee 15/2002, 8 October 2002, Item 4

these bodies which, therefore, must meet the same financial reporting and auditing requirements.[5]

The *Annual Reports (Departments) Act 1985* and the *Annual Reports (Statutory Bodies Act) 1984* (the Annual Reports Acts) specify annual reporting requirements for these bodies by referring to Schedules 2 and 3 of the Act. This means that inclusion of an agency in either of these schedules links financial reporting, auditing and annual reporting requirements. However, the audited financial reports of agencies controlled by another agency are included in the report of the "parent" agency and they do not have to prepare separate annual reports.

The Act provides that the Governor may amend the Schedules by proclamation in order to add new organisations, change their names or remove them should they cease to exist. Removal from the Schedules on other grounds would require a regulation.[6] Agencies are also added to or removed from the schedules by legislation, particularly enabling legislation.

Invited audits

Sections 44(1) and 45 of the Act provides for the Auditor-General to be invited to audit other organisations included in the regulations. These may otherwise fall outside the ambit of the Act. There are currently 45 organisations listed for this purpose in the *Public Finance and Audit Regulations 2000*. While some of these, such as the Art Gallery of New South Wales Foundation and the Macquarie University Professional Superannuation Scheme, are large and complex, many are not. For instance, in 2000-2001, the Agricultural Scientific Collections Trust had an income of $34,000.

The Governor includes these organisations by regulation. There does not appear to be any process for reviewing the appropriateness of the list.

The Annual Reports Acts do not apply to these bodies.

Legislative Change

While it is possible to remove an agency from Schedules 2 and 3 to the Act and from the regulations, any other generic change to reporting arrangements would require changes to the Act or the Annual Report Acts. For instance, if it is considered that some types of agency do not need to prepare detailed financial reports but should continue to prepare annual reports, the Act would need to be amended.

Applicability of Australian Accounting Standards

As noted above, the Australian Accounting Standards also apply to public sector entities. These standards require "reporting entities" to prepare general purpose financial statements. While generalisation about the application of the Standards

[5] Sections 39(1A), 45A(1A)

[6] Sections 40 and 45B.

to all circumstances is difficult, there is a presumption in the Statement of Accounting Concepts that most government departments and statutory bodies would be fall into classification of “reporting entity.[7] This means that, even if the requirement for a particular entity to prepare financial statements is not included in legislation, there may still be a requirement for such statements under the accounting standards.

Issues

Purpose of financial and annual reports

A fundamental consideration is the reason for requiring agencies to prepare financial and annual reports and to be audited.

The public clearly has an interest in understanding how publicly controlled organisations perform. The Committee considers the purpose of preparing financial reports is to ensure both financial transparency and accountability by informing the public, through the Parliament, about the performance of agencies in the State Sector so that appropriate decisions can be made about the State Sector.

This is consistent with the objective of private sector financial reporting. For instance the Australian Accounting Standards defines the concept of “reporting entity” as:

> an *entity* (including an *economic entity*) in respect of which it is reasonable to expect the existence of users dependent on *general purpose financial reports* for information which will be useful to them for making and evaluating decisions about the allocation of scarce resources[.][8]

The key to this definition is that there are users reliant on this information.

It is the intention of Parliament that public sector organisations have stringent accountability requirements whether they are dependent on the Budget for funding, Public Trading Enterprises or subsidiaries of agencies. This intention is supported by the Executive. For instance, a Premier’s Memorandum required Ministers to establish subsidiary companies only in such a way that they would be subject to Parliamentary scrutiny through reporting requirements and audit by the Auditor-General.[9]

However, an important consideration is the degree of usefulness of this information for making decisions about resources when some of these agencies have few assets, low budgets, and low risk of failure. For instance, any financial

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[7] Australian Accounting Research Foundation, Statements of Accounting Concepts, SAC 1 *Definition of the Reporting Entity,* paragraph 24

[8] AAS 1024

[9] Premier’s Memorandum 91/02 *Guidelines for the Formation and Operation of Subsidiary Companies by Departments and Statutory Authorities.* Recent amendments to the Act ie section 39(1A) and 45A (1A) affect the operation of the Premier’s Memorandum.

risk associated with the accounts of a very small agency would not be material to the Total State Sector Accounts or even to a larger agency.

The Committee notes that reporting requirements vary for different sorts of private sector entities. The *First Corporate Law Simplification Act 1995* introduced the concept of "small proprietary companies" which meet two of the three criteria of having 50 or fewer employees, $5 million in assets, and revenue of $10 million or less. Small proprietary companies are not required to prepare annual financial reports and directors' reports unless ASIC or shareholders direct them to do so.[10]

However, the Committee notes that proprietary companies, by definition, have a maximum of 50 non-employee shareholders who would be interested in the financial information. This differs significantly from public sector agencies where, arguably, the entire state is interested in this information.

The Committee also notes that the Commonwealth Parliamentary Joint Statutory Committee on Corporations and Securities recently recommended that this differential reporting be replaced with the previous arrangements for exempt and non-exempt proprietary companies. This was because, in part, of the difficulties arising from the differences in definitions between "large proprietary companies" and the concept of "reporting entity" in the accounting standards.[11]

The Committee is seeking comments on whether there are any advantages and disadvantages in reducing the level of scrutiny applicable to small agencies and, if so, what criteria would be appropriate.

Questions for consideration

1. Who are the users of financial and annual reports? The Parliament? The Government? The public?
2. Do the Parliament and the public need to know the detailed financial circumstances of very small entities?
3. Does the need for accountability for public money and assets outweigh any possible efficiency gains by reducing the number of agencies required to prepare reports and be audited?
4. Would there be any benefit in reducing the level of scrutiny for small agencies? If so, what criteria would be appropriate?
5. Is it essential to maintain a link between financial reporting requirements and the need to prepare an annual report?

[10] Corporations Act 2001, Sections 45A(2), 292-294

[11] Parliamentary Joint Statutory Committee on Corporations and Securities, *Report on aspects of the Regulation of Proprietary Companies*, Parliament of the Commonwealth of Australia, Canberra, 2001, pp 33-35

Questions for consideration

6. Would the State's financial reporting be subjected to any additional risks by creating differential levels of reporting?
7. Who should review classifications under a system of differential reporting? How often? Should these reviews be subject to Parliamentary scrutiny?

Reporting Costs

There are a number of issues to balance against the need for accountability and the usefulness to the public of the information included in reports. These include the costs to agencies of preparing financial statements and annual reports and of auditing.

It is likely there are economies of scale for such reporting, making the exercise relatively more expensive for smaller agencies. The Executive has expressed a desire to lower the costs of annual reporting in the past by, for instance, limiting the use of external consultants to prepare the report for publication and reducing the number of copies printed.[12]

The Government has also tried to reduce the cost of corporate services for agencies through the use of Central Corporate Services Unit and the recent Strategy for Shared Corporate Services. This Strategy estimates savings for corporate services including financial management in the order of 30 per cent.[13]

In the private sector, the Australian Securities and Investment Commission (ASIC) has the power to issue class orders to exempt controlled entities from the need to prepare separate financial and annual reports. Information about the controlled entity is included with the report of the parent organisation.[14] This differs from the public sector requirements because controlled agencies are still required to prepare complete financial reports for auditing. The Committee notes however that the relationship between private and public sector parent entities and controlled entities is not usually directly comparable.

The Committee is seeking information about the level of resources needed to prepare these reports and whether this is an efficient use of resources.

If it is considered onerous for some agencies, options to improve efficiency could be to allow differential amounts of reporting for smaller entities. These could provide concise reports on such information as contingencies and liabilities.

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[12] Premier's Memorandum No 98-04 *Production Costs of Annual Reports*

[13] Shared Corporate Services Strategy downloaded from http://sharedcorporateservices.premiers.nsw.gov.au/csss/ 14 November 2002

[14] ASIC Class Order 98/1418 *Wholly Owned Entities*

The Committee is seeking information about what level of funds, risk or complexity would be appropriate for making such an option available.

Questions for consideration

8. What level of resources are required to prepare annual and financial reports? Is this onerous for small agencies?
9. Would it be appropriate to enable smaller, low risk agencies to prepare less comprehensive financial reports?
10. If so, what criteria for would provide the right balance between risk and accountability?
11. What should be included in a concise financial report?
12. How often should decisions be made about an agency's reporting requirements?

Costs of audit

The Audit Office conducts its financial audits on a fee for service basis. Costs depend on the time taken and the seniority of staff performing the audit. In the case of controlled agencies, these are paid by the "parent" agency.

The Committee is seeking information about appropriate criteria for defining an agency as "small". In response to this question, the Audit Office has advised that of the 420 audits it performs each year, around 150 take less than 100 hours. The average fee charged for these audits is $3,500 although the range is from $1,000 to $8,500. Around a third of these agencies are controlled by another authority but the remainder are independent.[15]

For very small entities this cost could be unduly onerous. For instance, in 1998/99, the Cowra Japanese Garden Trust, paid audit fees of $2,500 when its total income was $49,000 and assets were around $500,000.[16]

There are a certain number of fixed costs for every audit although the Audit Office stated that these are hard to specify. However, the Audit Office has advised that, in order to conform with both the auditing standards and the Act, they must perform these steps regardless of the size of the audit:

- issue an engagement letter;
- ensure the quality of the audit process through appropriate supervision;
- properly document the audit for instance through plans, programs and evidence;

[15] Correspondence from Mr R J Sendt, Auditor-General, to the Committee Chairman, 22 October 2002

[16] Audit Office Annual 1999/200 report, p 50, Auditor General's Report to Parliament 2000, vol 5, p 373

- review annual reports to confirm that disclosed information is consistent with the audited financial report;
- obtain representations from management (usually in the form of a letter);
- investigate subsequent events;
- test the "going concern" assumption;
- issue an Independent Audit Report;
- issue a Statutory Audit Report to the Minister, Treasurer and agency head; and
- report to Parliament.[17]

There is an in-built inefficiency in the audit of small agencies as auditors must decide whether accounts are materially correct. The dollar value of the point at which an issue becomes material to the accounts depends on the size of the organisation. For small agencies, the auditors may spend a great deal of time dealing with very small transactions. What is material to small agencies is unlikely to be material for larger agencies. For instance, $10 million may not be material to the accounts of the Department of Education but it is larger than the entire budget of some other agencies.

A further consideration is that the size of the audit is not necessarily directly related to the size of the agency. The audit's level of complexity could vary due to the type of activity the agency performs and the strength of its internal control systems. Very small agencies may lack financial expertise and require greater assistance from the auditor to comply with requirements while larger agencies may have strong controls.

Options for changing auditing requirements

The Committee considers that auditing is of vital importance for accountability of public funds. However, in order to ensure that the costs of auditing are justified by the benefits, it is seeking information about the usefulness of auditing small agencies and, in particular, the need to audit controlled entities separately from the parent entity.

In the case of controlled entities, one option could be to require that they be audited with the parent entity. Under this model, in most years, the auditor would only need to ascertain enough information about the small agency to ensure the statements of the parent agency were materially correct. In some years, perhaps every third year, the small agency could be audited in more detail. One concern with this model is that legislative change may not remove obligations for separate audit under the accounting standards.

In the case of independent agencies, the Committee invites suggestions for balancing the need for accountability against efficiency.

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[17] Correspondence from Mr R J Sendt, Auditor-General, to the Committee Chairman, 22 October 2002

The Committee considers that there are a range of factors which need consideration in deciding whether an agency should be audited. These include:

- size and significance of the agency;
- complexity of its business activities and transactions;
- sensitivity to changes in the environment in which it operates;
- legal form and structure; and
- external and internal risks.

The Committee is seeking advice regarding the appropriateness of these factors and other factors that should be considered.

The Committee is also seeking information about the appropriate forum for deciding the level of reporting requirements for agencies.

Questions or consideration

13. What are the risks if the level of audit for small entities is reduced?
14. Has the Audit Office added any benefit by performing reviews of very small agencies included in the PFA Regulations by identifying accounting control problems or other financial management issues?
15. Who should decide whether organisations are subject to this level of scrutiny? The Government? The Treasury? The Parliament?
16. What should be the criteria for deciding the reporting requirements for agencies? For instance, should it be the size of the budget, assets or whether their activities are commercially focussed?
17. Should there be a regular revision of the organisations included in the invited audits list?

Situation in other jurisdictions

The Committee would be interested in information about the circumstances in other states and territories, the Commonwealth and overseas in relation to reporting and auditing practices.

Next steps

The Committee is seeking submissions to this inquiry from all interested parties and expects to prepare a report during 2003.

Please forward any comments you may have on this discussion paper or any other matter related to this inquiry to

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