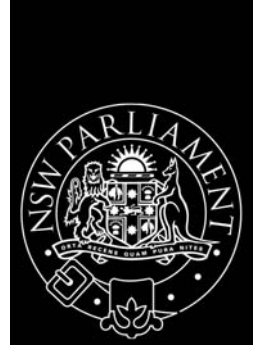


LEGISLATIVE ASSEMBLY



Public Accounts Committee

REVIEW OF OPERATIONS OF AUDIT COMMITTEES

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Charter of the Committee

The Public Accounts Committee has responsibilities under Part 4 of 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.

The Committee, which was first 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. A key part of committee activity is following up aspects of the Auditor-General's reports to Parliament. The Committee may also receive referrals from Ministers to undertake inquiries. Evidence is gathered primarily through public hearings and submissions. As the Committee is an extension of the Legislative Assembly, its proceedings and reports are subject to Parliamentary privilege.

Terms of Reference

On 23 June 2004, the Committee resolved to commence a Follow-Up Inquiry on issues raised in the Auditor-General's Compliance Review of the Operations of Audit Committees of May 2002.

The Terms of Reference for the Inquiry are to examine:

- whether New South Wales government agencies are aware of the Auditor-General's report, and
- how agencies responded to the recommendations in that report.

Chairman's Foreword

I am pleased to present this Committee report of its inquiry into the operation of audit committees. The inquiry followed up the Auditor-General's "Compliance Review of the Operations of Audit Committees".¹ The Auditor-General's Report identified a range of improvements audit committees could make to help their agencies achieve best practice.

In our inquiry, the Committee was pleased to receive a very high response rate to its questionnaire, the principal means of gathering information for the inquiry process. Committee members were also pleased to note that all respondents had an audit committee in place, or (because of restructuring arrangements) were in the process of forming one. There was general acceptance of the principle that operational audit committees greatly assist the good corporate governance of agencies.

However, the Committee was perturbed to note that not all of the improvements identified in the Auditor-General's Report in relation to audit committees had been implemented by all agencies. The Committee was particularly concerned that some government agencies still had no external members on their audit committee. Further, in some government agencies, audit committees are still chaired by the Chief Executive Officer. This must cast some doubt on the capacity of those agencies to present audit committee processes as completely independent and transparent. The Committee felt the justification for this action, expressed in terms of CEOs' accountabilities to Ministers, was insufficient to override the corporate governance benefits offered by a properly-functioning audit committee. The Committee has thus proposed that this somewhat patchy performance should be progressed.

Through the questionnaire responses and public hearings, the Committee also identified a range of issues relating to ways in which the operations of audit committees can become more formalised, how audit committee members can become better trained and more aware of their scope and powers, and how audit committees can better communicate within agencies and externally about their activities.

I would like to thank all of the agencies who took the time and effort to respond in detail to the questionnaire, and those who gave of their time and expertise to participate in public hearings for the inquiry. I would also like to express my appreciation to the Secretariat for their assistance in the drafting of the report, in particular to Jackie Ohlin and Eloise Murphy for drafting the report. I would also like to thank David Daniels, who, as a secondee from the Audit Office, assisted the inquiry in its early stages. Finally, I would like to thank my fellow Committee members for their discussion of the matters raised in the report.



Matt Brown MP
Chairman

¹ Included in *New South Wales Auditor-General's Report 2002, Volume Three*, pp 3-6

Summary of Findings and Recommendations

The Committee observed that the value of agencies having an audit committee is to provide an independent view of how management is running the entity, to encompass risk management and to provide advice to the CEO and/or board about governance issues. The Committee believes that, although it is not mandatory, NSW Government agencies would benefit from adoption of the improvements identified as key findings in the Auditor-General's 2002 "Compliance Review of the Operations of Audit Committees". The Committee notes that previous guidance in relation to the operation of audit committees was issued from Treasury in 1995, in the form of best practice controls about internal control and governance principles.²

The Committee further believes that the adoption of these improvements for audit committees by agencies could be improved by a Treasury Direction to agencies. Accordingly, it makes the following recommendations.

Recommendation 1: That all NSW government agencies should have an operating audit committee, unless exempted by the specific NSW Treasury provisions relating to the agency's size, risk profile and capacity to maintain proper internal control and that the views of the Auditor-General be taken into account in this regard.

Recommendation 2: That NSW Treasury drafts a Direction to assist agencies to improve the operations of their audit committees, incorporating the following elements:

- That every audit committee should have a Charter or Terms of Reference addressing its operations, including the role of the audit committee in, at a minimum, undertaking a formal assessment of the performance of the internal audit function, overseeing the preparation of the agency's annual financial report and assisting the CEO during the external audit process
- That every audit committee of a Government department should have external members, and that the independence of members on audit committees of statutory authorities or State-Owned Corporations is specified in their respective Charters
- That neither the Chair of the board nor the Chief Executive Officer of the department should to be the chair of the audit committee
- That the audit committee should refer to good practice guidelines for its operations
- That the audit committee should communicate internally and externally about its operations at a minimum annually, and that external communications (chiefly in the Annual Report of the agency) should include reference to the frequency of and attendance at meetings; membership and criteria for membership; details of performance reviews; and, how performance has been benchmarked.

² NSW Treasury, *Statement of Best Practice: Internal Control and Internal Audit*, June 1995

Recommendation 3: When appointing members of audit committees, agencies should ensure that members are properly inducted and suitably qualified.

Chapter One - Background to the Inquiry

- 1.1 This report contains the findings and recommendations of the Public Accounts Committee's inquiry following up on issues raised in the Auditor-General's Compliance Review of the Operations of Audit Committees of May 2002.³

AUDITOR-GENERAL'S 2002 COMPLIANCE REVIEW

- 1.2 Compliance reviews are conducted by the Auditor-General to assess how well agencies address their obligations in relation to legal requirements, government policies or central agency directives. The Audit Office tests a representative sample of agencies on particular issues. In relation to the operation of audit committees, any identified areas of deficiency were referred to respective agencies for their attention. Recommendations can also highlight solutions that have broader application across the NSW public sector.⁴
- 1.3 In relation to the operation of audit committees, the Auditor-General's compliance review is contained in the *Auditor-General's Report to Parliament for 2002, Volume Three*. That review examined the operation of audit committees in 14 New South Wales government agencies, including seven government departments, five State Owned Corporations (SOCs) and two statutory bodies. As part of the review, a survey on the existence of audit committees was conducted with 69 large agencies. That survey found that audit committees actively exist in 62 of the 69 agencies. The key findings of the compliance review were:

Audit committees, while operating in the vast majority of NSW government sector agencies, are not present in some of the larger agencies.

Audit committees would be improved if:

- in government departments, at least one member of the committee is an independent person;
- neither the CEO nor the chair of the board is the chair of the audit committee;
- they undertook a formal annual assessment of the performance of the internal audit function;
- in government departments, they oversee the preparation of the agency's annual financial report and assist the CEO during the audit process;
- agencies report to external parties what the committee does and what expertise the members have and how well they attend meetings; and
- their performance is periodically reviewed.⁵

- 1.4 The Report recommended:

³ *New South Wales Auditor-General's Report 2002, Volume Three*, pp 3-6

⁴ *The Audit Office of New South Wales Annual Report 2004*, p 12

⁵ *New South Wales Auditor-General's Report 2002, Volume Three*, p 3

1. All large NSW government agencies should have audit committees.
2. Audit committees, particularly those operating in government departments, should consider their own activities and amend them where appropriate to accord with best practice, especially in the matters mentioned earlier.⁶

COMMITTEE INQUIRY PROCESS

- 1.5 The Committee undertook a survey of significant agencies as a first step in conducting this Inquiry. The Committee selected the largest 18 agencies in New South Wales, listed in Group 3 of Treasury Circular Number 04/03, and identified a further 15 agencies from which it sought responses, based upon their significance and to reflect a range of types of business. With new administrative arrangements introduced during 2004 in some of those agencies, a total of 36 agencies were surveyed. A list of agencies surveyed is at Appendix One.
- 1.6 The Committee sought detailed responses from these agencies concerning the existence of audit committees and their operations. The focus of the questions was on the agencies' responses to the key findings of the Auditor-General's Compliance Review. The questions included in the survey are listed in Appendix Two.
- 1.7 The survey achieved a very high response rate, with 33 agencies responding (91 per cent).
- 1.8 In addition to the survey, in October 2004 the Committee conducted public hearings with seven of the responding agencies. These hearings explored some of the issues raised through the questionnaire process. The hearings were held on 20, 22 and 27 October 2004 in Parliament House. Evidence was taken from representatives of the audit committees of the Department of State and Regional Development, NSW Police, Sydney Harbour Foreshore Authority, Energy Australia, Integral Energy and the Department of Community Services. Representatives of the Audit Office of New South Wales also appeared. The transcript of the hearings can be found on the Committee's website. A list of witnesses who provided evidence at the hearings is shown at Appendix Three.
- 1.9 The Committee considered and agreed to the draft report on 31 March 2005 and it was tabled on 6 April 2005.

STRUCTURE OF REPORT

- 1.10 Chapter Two describes the value of audit committees to corporate governance in the public sector. Chapter Three provides detailed analysis of the agencies' responses to the recommendations of the Auditor-General's Compliance Review. Chapter Four describes other possible areas for improvement identified by the Committee in conducting this inquiry.

⁶ *ibid*, p 3

Chapter Two - The Value of Audit Committees

A CORPORATE GOVERNANCE TOOL

- 2.1 The Auditor-General's Compliance Review indicated that all *large* New South Wales government agencies should have an audit committee. In his response to the Committee survey, however, the Auditor-General expressed the belief that New South Wales government agencies, "particularly the large agencies," should have well run audit committees.⁷
- 2.2 The Auditor-General subsequently indicated that, as a general principle, all government agencies would benefit from the existence of an audit committee. He noted that although audit committees are not generally expensive to establish or operate, there may be instances where the benefit would be minimal, which would be a function not just of agency size, but of the complexity of its operations and risk profile:
- That is, an agency which is small, has a narrow role and faces no significant risks, could operate without an audit committee. My view would be that this combination represents a very small proportion of public sector agencies.⁸
- 2.3 The NSW Treasury guidance indicates that: "special effort required on the part of senior management to maintain and support Internal Audit priorities" where organisations are small.⁹ The document also notes that NSW Treasury has responsibility for considering applications for exemption from the *Public Finance and Audit Act 1983* requirement for an internal audit function, which includes reference to the agency's size, risk profile and capacity to maintain proper internal control and takes into account the views of the Auditor-General.¹⁰ Should these exemptions apply, they may negate a requirement to establish an audit committee for small agencies.
- 2.4 This exemption would be consistent with comments made by the Public Sector Centre of Excellence of CPA Australia, a professional accounting association, in relation to governance in the local government sector. CPA Australia made a submission to the Committee on the use of audit committees which mentioned that the Association has developed a draft manual for local government bodies called *Excellence in Governance for Local Government*. This manual contains governance principles which could apply to any sphere of government. It includes as a best practice principle for councils to have internal structures that provide for independent review of processes and decision-making. CPA Australia's approach was not to mandate the use of audit committees because:

We believe that an entity should have in place a risk management function and if anything, it is this that should be mandated. The establishment of an audit committee function is a tool by which an entity can manage risk.¹¹

⁷ Correspondence from Auditor-General, 27 August 2004

⁸ Correspondence from Auditor-General, 21 February 2005

⁹ NSW Treasury, *Statement of Best Practice: Internal Control and Internal Audit*, June 1995.

¹⁰ *ibid*, 7.5

¹¹ CPA Australia submission

- 2.5 Comments on the draft manual have indicated that the size and available resources of many smaller councils would limit their ability to introduce an internal audit framework.
- 2.6 In evidence provided to the Committee, the Auditor-General noted that some government departments do not have audit committees.¹²
- 2.7 The Committee's survey of agencies confirmed that all respondents either have an audit committee or are in the process of forming one.
- 2.8 The principal benefit to agencies of having an audit committee derives from their capacity to support and enhance good corporate governance. An early *Best Practice Guide* produced for audit committees identifies the role of the audit committee as:
- ...assisting the board of directors to fulfil its corporate governance and overseeing responsibilities in relation to an entity's financial reporting, internal control structure, risk management systems, and the internal and external audit functions.¹³
- 2.9 More recently, the Australian Stock Exchange's Corporate Governance Council states that "the existence of an independent audit committee is recognised internationally as an important feature of good governance."¹⁴ Deloitte also echoes these sentiments, arguing that audit committees have been a corporate governance feature, both enhancing confidence in the integrity of organisations, but also helping those organisations to improve their performance.¹⁵
- 2.10 These outcomes of good corporate governance and a mechanism to improve performance are also recognised as desirable for public sector agencies. The NSW Treasury comments:
- Best practice now encourages all organisations in both the public and private sectors to establish an effective Audit Committee, unless there is a conflict with an existing statute.¹⁶
- While there is guidance in terms of Treasury's Statement of Best Practice, there are no defined rules to enforce a commitment by NSW government agencies to the effective operation of audit committees.
- 2.11 The survey indicated that agencies have been receptive to the Auditor-General's recommendations arising from the 2002 Compliance Review. This may, in part, reflect a general movement toward good practice in corporate governance. It may also reflect a level of concern with the implications of past poor corporate governance practice. As the NSW Auditor-General has stated:
- When businesses fail, the public forgets that risk-taking and entrepreneurship are fundamental to the market economy we live in. Failures are inevitable. Small companies fail everyday and people get hurt financially.

¹² Transcript of Evidence, 22 October 2004, p 17

¹³ Australian Accounting Research Foundation, Australian Institute of Company Directors and the Institute of Internal Auditors, *Audit Committees: Best Practice Guide*, 1997, p 2.

¹⁴ ASX Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations*, 2003, page 30.

¹⁵ Deloitte Touche Tohmatsu, *Audit Committees: A Practical Guide*, (undated), p 7.

¹⁶ NSW Treasury, *Statement of Best Practice – Internal Control and Internal Audit*, June 1995, 4.6

But when large companies fail, particularly those that deal with the public, the impacts are more widely spread and visible. So the cry goes out to label someone as responsible. The failures of Enron and WorldCom in the United States, Harris Scarfe, One-Tel, HIH and Ansett in the private sector in Australia and the NSW Grains Board in the public sector have focussed public attention as never before on the role of managers, directors and auditors.¹⁷

- 2.12 The Committee was pleased to note a range of views expressed in response to its survey by agencies about their understanding of the value of an effective audit committee. These values include the audit committee's transparency, capacity for probity, demonstrable ethics and clear accountability both to external stakeholders and to staff within the agencies themselves.
- 2.13 In evidence provided to the Committee, Mr Jon Isaacs, Chair of the Sydney Harbour Foreshore Authority and former Chair of the Audit Committee, commented:
- Mr Isaacs:** It [the Audit Committee] is an opportunity also for the staff of the organisation to see the board members behaving and displaying attitudes, which are consistent with the values of probity and ethical behaviour. It has that very important effect. I think too it demonstrates to the public at large that there is an external beacon being shone on the financial and operational workings of the organisation.¹⁸
- 2.14 Other agencies also reported on the value of the audit committee in setting a framework for corporate governance. For example, Energy Australia indicated that the duties of the Audit Committee, documented in its Charter, embrace governance matters such as the preparation of financial accounts, reviewing risk management methodologies and addressing the internal culture of the organisation.¹⁹

THE SCOPE OF AUDIT COMMITTEES IN DEPARTMENTS

- 2.15 Despite a lack of mandatory requirements, the Committee was pleased to note the *prima facie* acceptance of the need for departmental audit committees by government departments. It noted, however, that some government departments differ from SOCs and Public Trading Entities (PTEs) in their interpretation of the scope of function of audit committees. The Committee observed a reluctance on the part of some agencies to allow audit committees the necessary powers and detachment from day to day operations to operate in accordance with best practice principles.
- 2.16 The Audit Committee of the Department of Community Services, for example, is chaired by the Director-General. This is not consistent with best practice. The Director-General argued the importance of this appointment in terms of his accountability for the performance of the agency to the Minister.²⁰ While the Committee has some understanding of the reasoning behind this view, it is concerned that the full value of the Department's Audit Committee may not be being realised, in particular in relation to any expressions of staff concerns about aspects of operations within the Department.

¹⁷ 'Integrating Business Planning and Financial Management to Drive the Budget Dollar Further'. Speech by NSW Auditor-General, Robert Sendt, to the IIR Conference on Public Sector Performance and Reporting, 20 April 2004, p 4. Available at www.audit.nsw.gov.au.

¹⁸ Transcript of Evidence, 22 October 2004 (Mr Isaacs), p 10.

¹⁹ Transcript of Evidence, 22 October 2004 (Mr Kean), p 30.

²⁰ Transcript of Evidence, 27 October 2004 (Dr Shepherd), p 6.

- 2.17 In a similar vein, the Department of State and Regional Development has an Audit Committee membership which is largely an extension of the management group, and also has no external²¹ member, although the Department's survey response indicated that appointment of an external member is under consideration.²² In evidence to the Committee, Mr Butterworth, Executive Director, Policy and Resources, indicated that committee composition was a result both of the Department's small size, but also of the desire to ensure appointment of personnel to the audit committee with direct responsibility for implementing its recommendations in their functional areas.²³
- 2.18 The Committee has some sympathy for the difficulties faced by smaller agencies in identifying appropriate people to sit on audit committees. However, it is concerned at the potential for lost opportunities to add value to the organisation with a robust audit committee undertaking clear and specific corporate governance functions.

THE ROLE OF AUDIT COMMITTEES IN ORGANISATIONAL DEVELOPMENT

- 2.19 Several witnesses noted that they see the audit committee as having made a positive contribution to the development of the organisation. For example, Mr Butterworth of the Department of State and Regional Development made the following comments on the introduction of the Department's Audit Committee:

Mr Butterworth: The committee has only been operative over 15 months.... We were not sure whether we would go ahead with it or whether it would give us the benefits we required. I have to report that it has been a pretty positive activity for us to do and I do not think we would be ever envisaging at this stage to move back to the way we were previously. It has proved quite valuable for us.²⁴

- 2.20 Similarly, the Chief Executive Officer of Integral Energy stated:

Mr Powis: I think in the interests of modern management openness and transparency is fundamental.... I actually think that the workings of the board and the workings of the Audit Committee are fundamental to keeping a check and balance on the business and moving forward.²⁵

CONCLUSION

The Committee acknowledges the importance of audit committees as a corporate governance tool. It was pleased that the use of audit committees was generally seen as of benefit to respective agencies.

²¹ Note: The term 'external' rather than 'independent' member of the Audit Committee is used in the Report and was deliberately chosen to reflect the reality that external appointments are made by the Executive of the agency and supported by agency staff.

²² Departmental submission, response to question 8

²³ Transcript of evidence, 20 October 2004, pps 1,2

²⁴ Transcript of Evidence, 20 October 2004 (Mr Butterworth), p 2.

²⁵ Transcript of Evidence, 27 October 2004 (Mr Powis), p 1.

Chapter Three - Agency Responses to Compliance Review Findings and Recommendations

INTRODUCTION

- 3.1 As noted in Chapter One, the Committee surveyed 36 agencies about the operation of their audit committees, and later took evidence from seven agencies. This Chapter discusses responses to the suggestions for improvements made in the Auditor-General's Compliance Review. Other opportunities for improving performance are canvassed in Chapter Four.
- 3.2 In response to the question about whether agencies have an audit committee, 32 of 36, or 88% of the respondents indicated that they have an audit committee. The Department of Primary Industries is the only agency without an audit committee. However the Department confirmed that an audit committee was to be established at the time of responding.
- 3.3 The high number of agencies with audit committees is consistent with the Auditor-General's observation that most agencies have established audit committees. In his submission to the Inquiry, the Auditor-General noted that the Audit Office's recent experience with audit committees suggests:
- most large agencies have audit committees and have substantially addressed most of the issues raised in the Audit Office's 2002 report on audit committees;
 - audit committees in large statutory authorities and SOCs are better run than in departments; and
 - not all audit committees in departments have independent members; nor do they all oversee the preparation of the financial report, periodically assess their own performance and assess the staffing, performance and qualifications of internal audit.²⁶

AWARENESS OF AUDITOR-GENERAL'S REPORT

- 3.4 The majority (85%) of agencies surveyed indicated that senior management were aware of the Auditor-General's Compliance Review. There was a mixed response to the question about whether changes had been made to the operations of the audit committee as a result of the Compliance Review (14, or 42%, indicated there had been changes made, 17 (51%) indicated there had been no changes made). This negative response was qualified in seven instances, however, by agencies' comments that changes were not considered necessary because the audit committee was already operating in accordance with best practice principles.
- 3.5 The following specific responses to the questionnaire indicate the extent to which the recommendations contained in the Auditor-General's Compliance Review have been acted upon by agencies.

²⁶ Submission No. 12.

External Person on Audit Committee

3.6 The following responses apply to both government departments and statutory authorities/SOCs. The latter are usually required under the terms of their organisational charter to have external non-Executive members on their boards. This means that there are external members to draw upon to be members of the audit committee.

3.7 Of the government departments responding, seven out of 12 indicated they had at least one external person on the audit committee.

3.8 The Department of State and Regional Development stated in a public hearing that it was considering external membership of its audit committee, in particular, appointment of an external member from the private sector. In this regard, the Executive Director, Policy and Resources, gave the following evidence:

Mr Butterworth: We still have the matter under consideration, but rather than look towards other government agencies and so on, we have been looking to have as a member somebody from a large industrial association, maybe from Australian Industry Group or Australian Business Limited or something like that.²⁷

3.9 Among large statutory authorities and SOC, 13 out of 20 responding indicated they had external members on the audit committee. One respondent, Legal Aid NSW, did not have external members of the audit committee. The Botanic Gardens Trust has external members, but indicated that its Charter does not require members of the audit committee to be external non-Executive members. For two respondents, a response to the question was not evident.

3.10 In responses to questioning about external members on audit committees, a number of witnesses and respondents indicated that representatives of the Audit Office and externally appointed internal auditors regularly attend audit committee meetings. The Auditor-General made the following comments on the issue of external members of audit committees:

Mr Sendt: Our view is generally that there certainly should be independent members on the committee and that ideally there should be an independent chair of the committee.²⁸

In the Committee's view, having the Auditor-General, representatives of the Audit Office or internal audit representatives attend meetings does not constitute having an external member on an audit committee. Whilst such representatives may attend as observers or professional advisors, this does not mean they are external members.

3.11 However, the Auditor-General also recognised that:

Mr Sendt: ...in departments it is often difficult to get independent members who understand the business. In GTEs [Government Trading Enterprises] and SOC the audit committees are made up generally of members of the board and those members therefore have a relationship with the organisation and understand it. With departments there are no boards and therefore an independent member has no

²⁷ Transcript of Evidence, 20 October 2004 (Mr Butterworth), p 1.

²⁸ Transcript of Evidence, 22 October 2004 (Mr Sendt), p 18.

ongoing relationship with the organisation, other than being on the audit committee, so there is a different degree of understanding of the organisation. It is difficult to get independent members who do have an understanding of the organisation....

I think to have, for a department, an audit committee that consisted of a majority of independent members is probably difficult to achieve and certainly for smaller organisations I would suggest is probably inappropriate.²⁹

3.12 The Department of Community Services made the following comments on the process for identifying suitable external candidates for the Department's Audit Committee:

Dr Shepherd: They were selected by going to the various agencies who basically hold auditors, if you like, so the chartered accountants group, the audit professional bodies and so on, getting advice from them and then selecting by an open process.³⁰

3.13 The Committee notes that common membership occurs across audit committees. For example, one person is the external audit committee member for three separate Departments (NSW Police, Department of Corrective Services and the Department of Housing), and is the Chair of two of these (Police and Housing).

Committee Chair Neither CEO nor Chair of the Board

3.14 Twenty-one respondents (64% of respondents) indicated that the Committee Chair is neither the Chief Executive Officer (CEO) nor the Chair of the Board. Three respondents did not provide a response, or said the question was not applicable. Those that had, or will have, a CEO or Chair of the Board as Committee Chair include:

- the Public Trustee
- Department of Community Services
- Attorney-General's Department
- Department of Corrective Services
- Department of Juvenile Justice
- Botanic Gardens Trust
- TCorp
- Department of Environment and Conservation
- Roads and Traffic Authority
- NSW Health

3.15 The NSW Police Service reported that it has recently appointed an external Chair to its Audit Committee. On the benefits of having an external person chairing the Committee, Commissioner Moroney provided the following comments:

Commissioner Moroney:...one of the things we have been keen to push is the openness and transparency of the organisation, and I think one of the great values of having an independent chair is that very notion of openness and transparency, a chair that will tell you honestly and frankly about the organisation's performance...

²⁹ Transcript of Evidence, 22 October 2004 (Mr Sendt), pp 18-19.

³⁰ Transcript of Evidence, 27 October 2004 (Dr Shepherd), p 5.

I think the true value of an independent chair is about the ability to see past a range of issues that help you think more strategically and more tactically when the bleeding obvious is right in front of you.³¹

- 3.16 The external Chair of the NSW Police Audit Committee, Ms Carol Holley, also provided evidence on the role of an external Chair:

Ms Holley:...what I bring...is a wider experience in the corporate world and the financial world of governance and how in a really practical sense audit committees in other organisations work and how relationships with auditors work and with internal audit units...[I bring] an outside, independent view, having no police links at all, perhaps just to say this is how a large organisations in another place might view such matters.³²

- 3.17 As noted above, it is the view of the Auditor-General that organisations should ideally have external chairs. The Deputy Auditor-General further indicated that the Audit Office's view is that the CEO should be in attendance at audit meetings but not as a member of the committee.³³

- 3.18 There are still a number of agencies where the Chair of the Board or the Director-General of the Department is in fact the Chair of the Audit Committee. In the case of the Department of Community Services, the Audit Committee is chaired by the Director-General of the Department. The Director-General explained the reasoning for this decision in his evidence at the public hearing:

Dr Shepherd: If you look at the structure of inner budget sector agencies versus private sector public companies there are some substantial differences. In the case of an inner budget sector agency, the Director-General has the sole responsibility to the Minister for the department and under section 11 of the *Public Finance and Audit Act* it is the Director-General who is responsible for the internal control mechanisms.

If you look at the function of internal audit as being two-fold, the first is to satisfy me, since I am the accountable person to the Minister, that I have the systems and controls in place to manage the agency effectively and to meet the accountabilities that I have to administer and, secondly, to do audit work of a sufficient breadth and to a sufficient standard to satisfy the external auditor that they do not need to do a total audit for the agency. So they are the two things that I think internal audit does. If we focus on the first one of those, which is the advice to me about the controls, then I would argue that it is logical that I should chair the committee since I have the greatest interest in the outcome from the committee and, if it does not work, I am the loser since I am the one who has the accountability for the performance of the agency to the Minister. The other thing is that no independent that you bring in will have sufficient knowledge of the complex business that the Department of Community Services is engaged in to really chair that committee effectively and to know when something is not likely to be right. One of the skills you get as a Director-General is that you get a pretty good nose for what is or is not right sitting underneath you. I think the fundamental difference is that if you had a board, either as a private sector company or as a public sector enterprise with a board, and some of those are inner budget sector agencies, like the Environment Protection Authority, then you can get a member of the board to chair the committee. The member of the board should have a substantial knowledge of the workings of the

³¹ Transcript of Evidence, 22 October 2004 (Commissioner Moroney), pp 2-3.

³² Transcript of Evidence, 22 October 2004 (Ms Holley), p 2.

³³ Transcript of Evidence, 22 October 2004 (Mr White), p 19.

agency and it is not like just almost buying an independent off the street who is an auditor solely rather than someone who has a much broader range of experience.

My view is that, in an inner budget sector agency with no board, the Director-General ought to chair the committee if he has a sufficient interest in the audit function.³⁴

- 3.19 The Committee noted that this view is not inconsistent with any mandatory requirements. However, in the view of the expert opinions of best practice in corporate governance the Committee considers the arrangements in the Department to be less than ideal.

Formal Assessment of Performance of Internal Audit Function

- 3.20 Twenty-eight respondents (85%) indicated that the audit committee annually assesses the performance of the internal audit function.
- 3.21 Three respondents (TCorp, Eraring Energy and Integral Energy) indicated they do assess the performance, but informally. One respondent (Office of State Revenue) indicated that while it does not undertake an annual review, it does review the progress of plans. One agency, Department of Primary Industries, indicated that it will perform a formal assessment once the audit committee is established. The Public Trustee indicated that it does not undertake a formal assessment of the internal audit function.

Oversight of Preparation of Agency's Financial Reports and Assisting CEO in Audit Process

- 3.22 There were three questions in the survey dealing with this issue. Agencies were asked to indicate whether the audit committee reviews:
- a. the accounting policies of the agency;
 - b. significant estimates and judgements in the financial report; and
 - c. compliance of the financial report with laws, regulations and standards.
- 3.23 Twenty-four respondents (72%) indicated the audit committee reviewed accounting policies of the agency. Five respondents (17%) did not. These were:
- the Public Trustee (which indicated that these matters are reviewed at Executive level)
 - Attorney-General's Department
 - Department of State and Regional Development (which reported it would consider all three of the above on its forward agenda)
 - NSW Health

³⁴ Transcript of Evidence, 27 October 2004 (Dr Shepherd), p 6.

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- Delta Energy.

The Department of Primary Industries and Forests NSW Audit Committees are yet to meet.

3.24 Twenty-three respondents (70%) indicated they review significant estimates and judgements in the financial report. Five indicated they did not. These were:

- the Public Trustee
- Attorney General's Department
- Country Energy (which noted that the Board reviews these)
- Department of Corrective Services
- Office of State Revenue.

The latter indicated this was not possible due to tight timeframes, but noted that in the past, where issues had arisen, an extraordinary meeting of the committee had been called.

3.25 Twenty-two respondents indicated that the audit committee reviews compliance of the financial report with laws, regulations and standards. Six did not. These were:

- the Public Trustee
- Attorney-General's Department
- Office of State Revenue
- Delta Energy
- Macquarie Generation (which noted it relies upon the CEO, Managing Director, CFO and Company Secretary for compliance)
- NSW Health.

3.26 Asked whether the audit committee makes a recommendation to the CEO/board on the signing of financial reports, 24 respondents (73%) indicated that this is the practice. Six said it did not. These were:

- the Public Trustee
- Attorney-General's Department
- Department of State and Regional Development (which noted it would consider the suggestion on its forward agenda)
- Office of State Revenue
- Department of Juvenile Justice (which indicated, however, that discussion occurs)
- NSW Health (which indicated it is reported at the following meeting).

3.27 Asked whether the audit committee reviews all representation letters to be signed by management and given to the auditors, 19 respondents (63%) indicated this does occur. Ten respondents (33%) said it does not occur. These were:

- the Public Trustee
- Attorney-General's Department

- Sydney Olympic Park
- Department of State and Regional Development (on forward agenda)
- Integral Energy
- Office of State Revenue
- Botanic Gardens Trust
- Roads and Traffic Authority,
- NSW Health (noted that this is reported at the following meeting)
- Eraring Energy.

The Art Gallery of NSW indicated that this had not occurred in the past, as the CEO and CFO were on the Committee, but would occur in the future. The Department of Environment and Conservation noted that the previous Committee did not perform this role.

3.28 On the benefits of audit committees reviewing the preparation of financial reports, the Assistant Auditor-General commented:

Mr White: The value in statutory bodies and SOCs where the audit committee adds value to the preparation of [financial reports] is not actually in forming the figures, it is on that one step back before they come for audit review of looking at these with an independent set of eyes and saying do these make sense and what is it saying about the organisation. Sometimes having it just with the CFO [Chief Financial Officer], the person who is really preparing the information, you do not get that distinction between preparer and reviewer.³⁵

3.29 The Committee is pleased to note the extent to which the audit committees of most agencies surveyed are taking an active role in the preparation of the agency's financial reports and assisting the CEO in the audit process. It feels, however, that in some areas, particularly relating to the oversight of representation letters, that there is room for improvement.

Reporting to External Parties on Audit Committee Functions

3.30 Agencies were asked whether they included information about audit committees in the most recent annual report. Follow-up questions asked specifically about the type of information presented.

3.31 Twenty-nine respondents (94%) indicated that the annual report of the agency includes a reference to the audit committee. Two did not (Department of State and Regional Development and NSW Health). However, in evidence at the public hearing, the Department of State and Regional Development indicated that there was no reference in the last annual report because the Audit Committee had only recently been established and that future annual reports would include information on the operation of the Audit Committee.³⁶

³⁵ Transcript of Evidence, 22 October 2004 (Mr White), p 22.

³⁶ Transcript of Evidence, 20 October 2004, (Mr Butterworth),p 1

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3.32 A further 20 respondents (67%) indicated that the annual report reference included a summary of the committee's responsibilities and activities. Five respondents indicated a partial reference. These were:

- Department of Corrective Services (Committee members listed in Appendix to Annual Report)
- Office of State Revenue (members are named and brief role description given)
- Department of Juvenile Justice (lists members and committee functions)
- Office of State Revenue
- Department of Housing (noting that the full information will appear in the forthcoming annual report).

Four respondents indicated that no summary of the committee's responsibilities and activities appears in the annual report. These were:

- the Public Trustee
- NSW Police
- Botanic Gardens Trust
- NSW Health.

The Department of Environment and Conservation noted that this did not occur for the former committee.

3.33 Asked whether the annual report reference included details of each member's term of appointment, expertise and attendance at meetings, 13 respondents (43%) indicated this occurred. Four respondents (15%) indicated a partial response (for example, to appointment date and attendance). The Audit Office reported that only the Chair's expertise is detailed. Nine respondents (30%) indicated that the specific reference did not occur. These were:

- the Public Trustee
- TCorp (which indicated these details would be included from this year)
- NSW Police, Attorney-General's Department
- Sydney Olympic Park
- Botanic Gardens Trust
- NSW Treasury
- Legal Aid NSW
- NSW Health.

There was no information on the matter from the Department for Juvenile Justice.

The Department of Environment and Conservation noted that this did not occur for the former committee.

3.34 Asked whether the annual report reference included the total number of meetings held during the year, 13 respondents (43%) indicated this did occur. Eight respondents (26%) indicated that it did not occur. These were:

- the Public Trustee

- NSW Police
- Attorney-General's Department
- Sydney Olympic Park
- Office of State Revenue
- Botanic Gardens Trust
- Legal Aid NSW
- NSW Health.

There was no information on the matter from the Department for Juvenile Justice. The Department of Environment and Conservation noted that this did not occur for the former committee.

- 3.35 The Committee believes this indicates that guidance on the sorts of information to be provided in annual reports about audit committees could be improved.

Periodic Reviews of Audit Committees

- 3.36 Sixteen respondents (53%) indicated that the audit committee had self-assessed its performance in the last three years. This was conducted by a range of means, including by self-completion questionnaire, by a private company, by the Company Secretary, or by using best practice guides.
- 3.37 The Sydney Harbour Foreshore Authority noted in evidence that it had conducted a self-assessment questionnaire on the operation of its Audit Committee in October 2004.³⁷ The questionnaire asked 26 questions of committee members, and average ratings for their responses were reported back to the committee. The key areas identified for improvement in the review were the identification of organisational risks and the management of those risks.³⁸
- 3.38 Eleven respondents (37%) indicated the audit committee had not self-assessed. These were:
- the Public Trustee (which indicated that changes are under way)
 - Department of Corrective Services
 - Department of State and Regional Development
 - Botanic Gardens Trust
 - Legal Aid NSW
 - Transgrid
 - National Parks and Wildlife
 - Roads and Traffic Authority (noted it is on the agenda for this year)
 - RailCorp (which intends to self-assess)

³⁷Transcript of Evidence 22, October 2004 (Mr Isaacs), p 14.

³⁸*Ibid.*

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- NSW Health (which reviewed the audit committee as part of its governance framework)
- Sydney Water.

Four agencies indicated that self-assessment reviews are pending. These were:

- Sydney Olympic Park
- Department of Planning, Infrastructure and Natural Resources
- Art Gallery of NSW
- Eraring Energy.

3.39 Asked whether the chair had assessed the individual contribution and performance of committee members as a result, eight respondents (30%) indicated this had occurred. Integral Energy noted that performance had been assessed on outcomes, not individual performance, and the Art Gallery of NSW noted that roles and contributions of members were monitored on an ongoing basis. The Department of Infrastructure, Planning and Natural Resources indicated that it intends for this to occur. Five respondents indicated that the chair had not assessed individual contributions and performance of committee members. These were:

- TCorp
- NSW Police
- Office of State Revenue
- Department of Housing (because of Departmental restructure)
- NSW Health.

Ten agencies (33%) indicated this question was not applicable. These were:

- the Public Trustee
- Sydney Olympic Park
- Department of Corrective Services
- Botanic Gardens Trust, Eraring Energy, Transgrid
- Sydney Harbour Foreshore Authority
- RailCorp
- Sydney Water
- Roads and Traffic Authority.

3.40 Thirteen respondents (43%) indicated that the agency's CEO/board had considered the results of the review. Three agencies indicated that this had not occurred. These were:

- the Public Trustee
- Country Energy (which indicated the Company Secretary collates results and presents them to the Board)
- TCorp.

All other respondents indicated this was not applicable, or else, there was no definitive answer to the question.

- 3.41 Thirteen respondents (43%) indicated that the review recommendations were acted upon, and a further two respondents indicated that there were no specific recommendations resulting from the review. All other respondents indicated the question was not applicable, or did not respond.
- 3.42 The Committee believes that this indicates opportunities to enhance the rate of self-assessment by audit committees.

CONCLUSION

- 3.43 The results of the Committee survey are consistent with the Auditor-General's observation that agencies are moving toward better practices in their use of audit committees. There are, however, some opportunities for improvement which are discussed in Chapter Five.

Chapter Four - Other Matters Relating to Operations of Audit Committees

INTRODUCTION

4.1 This Chapter discusses matters that arose in the course of this inquiry that were not addressed in the Auditor-General's report.

CLARIFYING THE ROLES AND RESPONSIBILITIES OF AUDIT COMMITTEES

4.2 In the Compliance Review, the Auditor-General concluded that the objectives of audit committees were "generally satisfactory."³⁹

4.3 The evidence provided at the hearings showed that there is a variety of views on the appropriate roles and responsibilities of audit committees. In survey responses and public hearings, the role of the audit committee was described either as oversight or responsibility for a range of matters, including:

- review of internal control systems and internal audit functions;
- review of performance audits and performance indicators;
- compliance issues;
- risk management;
- review of financial statements;
- liaison with external auditors and externally appointed internal auditors;
- an extension of the role of, or a sub-committee of, the executive management team;
- investigation of breaches of conduct and professional ethics; and
- consideration of corporate governance matters.

4.4 The Committee was concerned that, without clarification, audit committee members could be uncertain about their role. This might, in turn, lead to duplication with other governance bodies within the same agency, or alternatively, to issues falling "between the cracks", thus affecting the agency's performance.

4.5 A clear statement of the audit committee's roles and responsibilities would also help determine the priorities of the audit committee both for its own and for organisational, planning purposes. Treasury guidance provides a useful statement of the purpose of audit committees. In an appendix to its 1995 *Statement of Best Practice*, the following elements of an audit committee charter are identified. It states:

The charter should articulate the authority, responsibilities, and structure of the audit committee. The responsibilities, at a minimum, should address financial and other reporting practices, internal control, and compliance with laws, regulations and ethics. This charter should also state that the audit committee will meet periodically and may call additional or special meetings as needed.

.... The audit committee charter should also clearly state that:

³⁹ Audit Office of New South Wales, *Compliance Review of the Operations of Audit Committees*, 2002, p 4.

- The primary responsibility for financial and other reporting internal control, and compliance with laws, regulations, and ethics within the entity rests with executive management.
- The governing board or chief executive has oversight responsibilities in these areas, and the audit committee assists the governing board or chief executive in fulfilling these responsibilities. The audit committee must have unrestricted access to all information, including documents and personnel, and have adequate resources in order to fulfil its oversight responsibilities.
- It is important to have an impartial and objective assessment of the entity's management.
- The audit committee and the internal auditors should maintain a degree of professional independence when assessing management's performance of its responsibilities. However, this does not mean that an adversarial role is necessary or desirable because the internal auditors and management should have common goals.
- The chief executive and the governing body must support and endorse an audit committee which operates independently of management and is free of organisational impairments.
- In working to ensure the independence of the internal auditing function and that appropriate action is taken on audit findings, the audit committee should promote and enhance the mutual cooperation among the committee, internal auditors and executive management.⁴⁰

4.6 Further, a clear statement of the audit committee's roles and responsibilities would help to determine the specific skills and expertise required in committee members.

USE OF CCSU SERVICES

4.7 A number of smaller agencies such as the Department of State and Regional Development are members of the Central Corporate Services Unit (CCSU). These organisations rely upon the CCSU for all their accounting needs.

4.8 While providing some economies of scale, the Committee noted that this arrangement might have the effect of denying to smaller agencies some of the choices or options available to audit committees in larger agencies. As Mr Butterworth pointed out in his evidence on the question of the adoption of accounting standards:

Mr Butterworth: We liaise with CCSU through a finance committee and have our say on matters, but by and large we do not get to say we want this element of it or that element. It is done on behalf of the collective as opposed to single members.... It does have implications and other government agencies are going towards shared services.⁴¹

⁴⁰ Institute of Internal Auditors, "The Audit Committee in the Public Sector", Appendix II, *Statement of Best Practice – Internal Control and Internal Audit*, NSW Treasury, June 1995

⁴¹ Transcript of Evidence, 20 October 2004 (Mr Butterworth), p 1.

SIZE AND CRITERIA FOR MEMBERSHIP OF AUDIT COMMITTEES

- 4.9 The NSW Treasury provides guidance but no rules regarding the size or criteria for membership of audit committees. It indicates that agencies whose governance structure includes a board should establish an audit committee along private sector lines, that is, comprising predominantly non-executive directors. For departments, it proposes a cross-section of senior executives and, where appropriate, external non-executive members.⁴² Appendix II of that document suggests that as a “general guideline” audit committees should have a minimum of three members.⁴³
- 4.10 Evidence provided at the hearing indicated that there are varying practices in relation to the size and composition of audit committees. The Department of State and Regional Development, has a large committee, consisting of all those managers who have responsibility for areas that may be subject to audit investigations. On the reasons for this approach, Mr Butterworth stated in his evidence:
- Mr Butterworth:** They [committee members] represent the personnel from all the areas where the audit functions investigate... and basically the personnel involved in this really are the ones responsible for carrying out the actual recommendations and that sort of thing. They are the implementation team as well, so it is important for them to actually get the information firsthand and that is one of the underlying reasons for having that large membership.⁴⁴
- 4.11 Other agencies have deliberately kept the size of the audit committee small. For example, the Sydney Harbour Foreshore Authority’s Audit Committee includes three non-executive directors of the Authority’s Board (although a number of staff, senior executives and external parties attend the meetings as observers). Similarly, Energy Australia’s Audit Committee comprises three members.
- 4.12 The Auditor-General commented in evidence that, in his view, any more than five members is not appropriate for an audit committee.⁴⁵
- 4.13 The size of the audit committee can be directly related to the skills base of audit committee members. In some instances, committee membership is determined on the basis of the managerial position held by the person within the organisation (often being those managers who will have responsibility for implementing the recommendations of the audit committee).
- 4.14 In other instances audit committee membership is based on ensuring that the required skill set for the audit committee is met through its membership. This means members are appointed on the basis of their specific skills and expertise relevant to audit committee functions. Apart from ensuring that the required skills set is achieved, this approach also addresses the potential conflicts of interest that arise through perceived failure to separate those who review performance from those who are responsible for managing programs and/or services.

⁴² NSW Treasury, *Statement of Best Practice – Internal Control and Internal Audit*, June 1995, 4.6

⁴³ *ibid*, Appendix II

⁴⁴ *ibid* p 2.

⁴⁵ Transcript of Evidence, 22 October 2004 (Mr Sendt), p 18.

4.15 On the question of balance between audit committee members having relevant expertise versus those with operational experience, Ms Holley, Chair of the NSW Police Audit Committee, said in evidence:

Ms Holley: I think you really do need the combination of people who have the qualifications and the background to understand where the organisation needs to go in a financial and risk sense and also the people who need to effect change.⁴⁶

4.16 The Auditor-General provided the following comments on the criteria for audit committee membership:

Mr Sendt:... it should be a matter of qualifications and the contribution that the individuals can make and the extent to which they can operate with an independent approach to the responsibilities of the audit committee as opposed to their day to day responsibility within the organisation.⁴⁷

COMMUNICATING THE ROLE OF THE AUDIT COMMITTEE INTERNALLY

4.17 This Committee report has documented the role of the audit committee in promoting good corporate governance (Chapter 2). Further, it has addressed the manner in which agencies have responded to the Auditor-General's identified improvement of communicating externally on the operations of the audit committee.

4.18 Several agencies and witnesses commented upon the additional value to the agency of communicating the role of the audit committee *internally*. The identified benefits included:

- bringing together staff across the agency, through the audit committee, thereby encouraging a corporate rather than divisional or individual unit view;
- unifying the agency's approach to reviews and in setting common standards; and,
- ensuring the culture of the organisation is commonly agreed and/or understood.

OPPORTUNITIES FOR KNOWLEDGE-SHARING

4.19 In their response to questionnaires and in evidence, respondents and witnesses identified the benefits to their audit committees of a range of good practice guides for audit committees drawn from both the private and public sectors. The noted good practice guides are included at Appendix Four.

4.20 However, as previously noted, there is very little guidance for audit committees that is recent and directly applicable to the NSW public sector.

4.21 The Committee acknowledged that, to a large extent, the value of good practice guides was revealed to audit committees through informal discussions between members of audit committees, and with the Audit Office or internal auditors.

⁴⁶ Transcript of Evidence, 22 October 2004 (Ms Holley), p 4.

⁴⁷ Transcript of Evidence, 22 October 2004 (Mr Sendt), p 18.

- 4.22 The Committee also noted that a number of agencies' audit committees tended to invite the participation of Audit Office personnel or internal auditors only to specific components of audit committee meetings. This approach may have the unintended consequence of excluding their significant expertise from matters under discussion by the audit committee. Both the Auditor-General and internal auditors who spoke with the Committee during the course of the inquiry indicated the desirability of audit committees drawing upon their expertise for entire meetings, rather than for disjointed segments.
- 4.23 The Committee was pleased to note that the Auditor-General had initiated a 'roundtable' of audit committee chairs, and saw this as a significant step in the sharing of good practice between audit committees.⁴⁸

TRAINING AND SUPPORT FOR AUDIT COMMITTEE MEMBERSHIP

- 4.24 The Committee noted the comments of the Assistant Auditor-General relating to the perceived need for an induction process on the public service for audit committee members from the private sector. This would ensure that those members can better understand their new operating environment and translate their previous private sector successes into the public sector context.
- 4.25 The Committee also noted the occurrence of common external membership on some audit committees, and felt that this could present either opportunities for information exchange, or the potential for 'narrowing the pool' of potential candidates for external positions. It suggested that there may be scope for agencies to broaden the range of sources from which they draw potential candidates; to publicly advertise when seeking new external members; and to ensure that external members receive an appropriate induction process on the processes of government and the relevant agency.
- 4.26 In a similar vein, the Committee believes that respective agencies should ensure audit committee members in general receive an appropriate induction upon the operations of the committee, including terms of reference and good practice guidelines.

VALUE OF AUDIT COMMITTEES TO AGENCY'S RISK MANAGEMENT

- 4.27 Survey responses and evidence presented at the hearings highlighted the critical relationship between the role of the audit committees and an organisation's risk management functions.
- 4.28 The Auditor-General's Compliance Review highlighted that audit committees can play an important role in relation to risk management and that risk management is an essential component of good corporate governance. The Auditor-General commented:
- The audit committee provides an opportunity where the CEO or the directors, the management and the auditors can meet to deal with issues relating to the management of risks and with financial reporting obligations.⁴⁹

⁴⁸ Transcript of Evidence, 22 October 2004 (Mr Sendt), p 23

4.29 On the importance of risk management issues to audit committees, Mr Isaacs of SHFA noted in evidence:

Mr Isaacs:... the issue of risk management is something which does have to be elevated because management of risk is not simply a negative. It is not simply a cost, it is actually an opportunity to see how you can do things better, and the constant pressure of any organisation, public or private or community sector....the constant pressure especially now is about how do you get a better outcome with less resources.

In the private sector there is an acceptance of a certain level of risk and people tolerate it. I think there is a higher tolerance of failure....in government it is quite the opposite. There is a very low level of tolerance of failure, but there is a high level requirement of making things happen, more things happen with less resources... It is a matter of how you manage that need to demonstrate entrepreneurship and hence risk taking in what is essentially a risk averse environment.

I think the issue of risk is an important matter because it is a driver of activity and operational efficiency and you have to do that in a way which is intelligent, sensible and [which] minimises risk.⁵⁰

4.30 Witnesses providing evidence at the public hearings highlighted the distinction between audit committees being responsible for risk management and having an oversight role in relation to risk management. For example, the Director-General of the Department of Community Services commented at the hearing:

Dr Shepherd: My view is that risk management is a primary function of the agency and not the Audit Committee.... Theoretically, I am responsible for risk management within the organisation because I am accountable for risk.....but in reality the executive collectively is responsible for setting up the risk profile and dealing with risk management across the spectrum of the things that we do. The Audit Committee's role in risk management, as far as I am concerned, is to examine the process that we have undertaken to develop the risk profile, to advise on the content of the risk profile..... and then to monitor the implementation of any strategies that are associated with the risk profile. I think they are really the respective roles of the two parts of the function, and they get the full risk profile and they do follow it up.⁵¹

4.31 The main findings from the survey responses and evidence presented at the public hearings relating to the relationship between audit committees and risk management functions were:

- risk management is increasingly a responsibility being overseen by audit committees (organisations that previously had separate audit and risk management committees are now incorporating them into one body);
- where the audit committee is not responsible for risk management, there should be clear lines of communication and reporting between the audit committee and the relevant risk management body within the agency;
- risk management tends to be better handled in SOCs and PTEs;

⁴⁹ Auditor-General's Report to Parliament 2002 (tabled 28 May 2002), Volume Three: Section One – Special Reviews – Compliance Review of the Operation of Audit Committees, p 6. Available at www.audit.nsw.gov.au.

⁵⁰ Transcript of Evidence 22 October 2004 (Mr Isaacs), p 14.

⁵¹ Transcript of Evidence, 27 October 2004 (Dr Shepherd), p 8.

- SOCS and PTEs tend to take a more positive view of risk; and,
- audit committees can play an invaluable role in promoting an internal culture which is supportive of risk management and internal control.

Chapter Five - Findings and Recommendations

Finding 1:

The Committee supports a position that all New South Wales government agencies should have audit committees, unless exempted under the specific NSW Treasury provisions relating to the agency's size, risk profile and capacity to maintain proper internal control and taking into account the views of the Auditor-General in this regard.

Recommendation 1:

That all NSW government agencies should have an operating audit committee, unless exempted by the specific NSW Treasury provisions relating to the agency's size, risk profile and capacity to maintain proper internal control and that the views of the Auditor-General be taken into account in this regard.

Finding 2:

The Committee notes that the relevant staff of the majority of agencies surveyed were aware of the Auditor-General's Compliance Review. Some agencies were not. However, on balance, the Committee found there was a willingness on the part of agencies surveyed to implement improvements to the operations of their audit committees. The actions taken by these agencies have, in the main, been designed to help improve corporate governance practice within agencies' audit committees.

Finding 3:

The Committee's survey results differ from the results of the Auditor-General's Compliance Review only in relation to one aspect of a detailed finding which indicated that the objectives of audit committees were "generally satisfactory."⁵² The Committee survey found that there were a number of instances in which audit committee members appeared to be unclear as to the specific objectives of their respective committees. It should be noted that the Committee surveyed a different sample of agencies to those in the Auditor-General's Compliance Review.

Finding 4:

The Committee believes that, although it is not mandatory, NSW Government agencies would benefit from adoption of the improvements identified as key findings in the Auditor-General's Compliance Review. The Committee notes that previous guidance in relation to the operation of audit committees was issued by NSW Treasury in 1995, in the form of best practice controls about internal control and governance principles.⁵³

The Committee further believes that the adoption of these improvements for audit committees by agencies could be improved by a Treasury Direction to agencies.

⁵² Audit Office of New South Wales, *Compliance Review of the Operations of Audit Committees*, 2002, p 4

⁵³ Transcript of Evidence, 22 October 2004 (Mr White), p 20.

Recommendation 2:

That NSW Treasury drafts a Direction to assist agencies to improve the operations of their audit committees, incorporating the following elements:

- That every audit committee should have a Charter or Terms of Reference addressing operations, including the role of the audit committee in, at a minimum, undertaking a formal assessment of the performance of the internal audit function, overseeing the preparation of the agency's annual financial report and assisting the CEO during the external audit process
- That every audit committee of a Government department should have external members, and that the independence of members on audit committees of statutory authorities or State-Owned Corporations is specified in their respective Charters
- That neither the Chair of the board nor the Chief Executive Officer of the department should to be the chair of the audit committee
- That the audit committee should refer to good practice guidelines for its operations
- That the audit committee should communicate internally and externally about its operations at a minimum annually, and that external communications (chiefly in the Annual Report of the agency) should include reference to the frequency of and attendance at meetings; membership and criteria for membership; details of performance reviews; and, how performance has been benchmarked.

Finding 5:

The Committee found that the use of various good practice guidelines by audit committees were useful tools to assist their effective governance. It commends the 'roundtable' of audit committee chairs, initiated by the Auditor-General, and would like to see this practice continue as a venue for information sharing.

Finding 6:

The Committee also observed that individual government departments, the Auditor-General and internal auditors had extensive knowledge and skills about the operations of government processes and audit functions which would form a useful and effective component of induction training for new external members of audit committees, in particular. Such information is considered necessary to initiate parties from the private sector into the nature of government sector operations. The Committee also believed that more general training for new audit committee members could usefully include such information.

Recommendation 3:

When appointing members of audit committees, agencies should ensure that members are properly inducted and suitably qualified.

Appendix 1- List of Agencies

List of government agencies surveyed as part of Audit Committee inquiry:

On 23 June 2004, the Committee agreed to conduct a follow up inquiry of the compliance review of audit committees by surveying the largest 18 agencies in NSW and a selection of 15 other significant agencies.

18 largest Agencies listed in Group 3 of Treasury Circular 04/03:

1. Country Energy
2. Delta Electricity
3. Department of Corrective Services
4. Department of Education and Training
5. Department of Environment and Conservation/National Parks and Wildlife/Botanic Gardens Trust
6. Department of Health
7. Department of Housing
8. Energy Australia
9. Eraring Energy
10. Integral Energy
11. Macquarie Generation
12. New South Wales Police Service
13. New South Wales Treasury Corporation
14. Rail Corporation New South Wales
15. Roads and Traffic Authority
16. State Forests (now known as Primary Industries Trading)
17. Sydney Water Corporation
18. TransGrid

Other agencies selected because of their significance and to reflect a range of types of business:

19. Department of Primary Industries
20. NSW Treasury/Office of State Revenue
21. Art Gallery of New South Wales
22. Attorney General's Department
23. Department of Community Services
24. Department of Infrastructure, Planning and Natural Resources
25. Department of Juvenile Justice
26. Department of State and Regional Development
27. Legal Aid Commission of New South Wales
28. Sydney Olympic Park Authority
29. Audit Office of New South Wales
30. Department of Commerce
31. Public Trustee Office
32. WorkCover Authority
33. Sydney Harbour Foreshore Authority

Appendix 2 - Questionnaire

PUBLIC ACCOUNTS COMMITTEE'S REVIEW OF AUDIT COMMITTEES QUESTIONNAIRE FOR SELECTED AGENCIES

General

The Auditor-General reported on the results of a Compliance Review of the Operations of Audit Committees in volume three of the *New South Wales Auditor-General's Report to Parliament, 2002* (pp 3-6). This questionnaire focuses on the areas for improvement identified in the report.

1. Does your agency have an audit committee? If yes, when was it established? If no, are the functions of an audit committee performed by another body and when was it established?
2. If your agency does not have an audit committee or equivalent, please document why not. (The rest of the questionnaire assumes the existence of an audit committee.)
3. Is Senior Management aware of the recommendations to improve the operations of audit committees made in the Auditor-General's Compliance Review?
4. Were changes made to the operations of your agency's audit committee as a result of the findings in the Compliance Review? If so, when were they put in place? Please provide details.

Membership of the Audit Committee

5. Please list the current members of the audit committee or equivalent by name, their full time position, and indicate how long they have been members.
6. Who is the chair of the audit committee, and what position within the agency does this person hold? How was the chair appointed?
7. If a board manages your agency, does the charter for the audit committee require members to be independent non-executive board members appointed by the board?
8. For Departments, are any members of the audit committee independent to your organisation? If yes, please indicate who. Have they ever been employed within your organisation? If yes, please provide details.

Overseeing Internal Audit Activities

9. Does the audit committee formally review the qualifications and staff of internal audit? If yes, please describe this process.

10. Does the audit committee annually assess the performance of internal audit? If yes, please provide details.

Dealings with External Audit

11. Does the audit committee review and consider the external auditor's annual plan and audit fee?
12. Does the audit committee provide the external auditor with the opportunity to discuss matters of significance arising from the audit, both during the course of the audit, and before finalisation of the audit report? How does this occur?

Financial Reporting of the Agency

13. Does the audit committee review:
 - a. The accounting policies of the agency
 - b. Significant estimates and judgements in the financial report
 - c. Compliance of the financial report with laws, regulations and standards?
14. Does the audit committee make a recommendation to the CEO/board to sign the financial report?
15. Does the audit committee review all representation letters to be signed by management and given to the auditors?

External Reporting of Audit Committee Activities

16. Does the agency's most recent annual report include a reference to the audit committee?
17. If yes, does the annual report include:
 - a. A summary of the committee's responsibilities and activities
 - b. Details of each member's term of appointment, expertise and attendance at meetings
 - c. The total number of meetings held during the year?

Periodic Review of the Audit Committee

18. Has the audit committee's performance been self-assessed in the last three years? If yes, when was it performed, and who performed it?
19. If a review was performed, did the chair assess the individual contribution and performance of members of the committee?
20. Did the agency's CEO/board consider the results of the review?
21. Were the review recommendations acted upon? Please provide details.

Appendix 3 - List of Witnesses at Hearing

20 October 2004, Parliament House

Organisation	Representatives
Department of State and regional Development	Mr Pearce Butterworth , Executive Director, Policy and Resources (and Chair of Audit Committee) Ms Janine Ricketts , Executive director, Business Strategy Mr Michael Milligan , Director, Business Governance

22 October 2004, Parliament House

Organisation	Representatives
NSW Police	Mr Ken Moroney , Commissioner Ms Carol Holley , Chair of Audit Committee Mr Dick Adams , Executive Director, Corporate Affairs Superintendent Robert Redfern , Chair of Audit Group
Sydney Harbour Foreshore Authority	Mr Rob Lang , Chief Executive Officer Mr Jon Isaacs , Chair Audit Committee Mr Andrew Kelly , Executive Director, Business and Financial Services
Audit Office of New South Wales	Mr Bob Sendt , Auditor-General Mr Lee White , Assistant Auditor-General
Energy Australia	Ms Lisa Maffina , Audit Committee Representative Mr Noel Kean , Chief Internal Auditor

27 October 2004, Parliament House

Organisation	Representatives
Integral Energy	Mr Richard Powis , Chief Executive Officer
Department of Community Services	Dr Neil Shepherd , Director-General and Chair of Audit Committee

Appendix 4 - List of Good Practice Guides Used by Audit Committees

Good practice guidelines identified in research and used by survey respondents include:

- Australian Accounting Standards, regularly updated on the NSW Audit Office website, www.audit.nsw.gov.au (see Professional Updates)
- AS 8000-2003 *Good Governance Principles*, Standards Australia, June 2003
- *Statement of Best Practice – Internal Control and Internal Audit*, NSW Treasury, June 1995;
- Corporate Law Economic Reform Program 9 policy statements and practice notes, Australian Securities and Investments Commission, www.asic.gov.au (see CLERP);
- *Principles of Good Governance and Best Practice Recommendations*, Australian Stock Exchange, March 2003;
- *Best Practice Guide - Audit Committees*, Australian Accounting Research Foundation, Australian Institute of Company Directors and Institute of Internal Auditors – Australia, 1997;
- *On Board*, Guide to Better Practice for Public Sector Governing and Advisory Boards, Audit Office of New South Wales, 1998;
- KPMG Best Practice Guide;
- Australian National Audit Office, *Better Practice Guide: Public Sector Audit Committees*, February 2005;
- *Audit Committees – A Practical Guide*, Deloitte Touche Tohmatsu;
- *Corporate Governance and Accountability in Health*, NSW Health;
- Global Auditing Information Network benchmarking tools, Institute of Internal Auditors, www.theiia.org (see GAIN Benchmarking, tools), and
- *Excellence in Corporate Governance for Local Government*, CPA Australia (forthcoming)