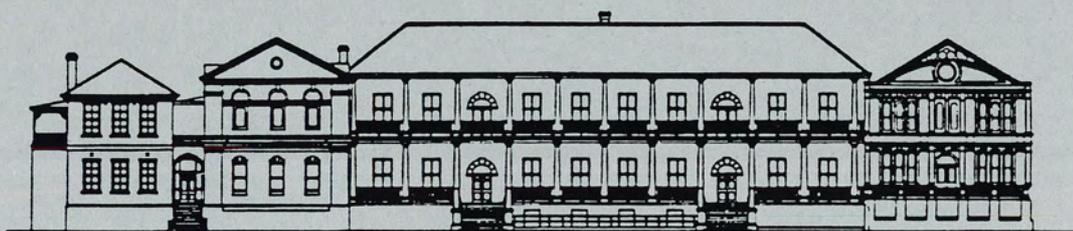


**PUBLIC ACCOUNTS COMMITTEE**  
PARLIAMENT OF NEW SOUTH WALES

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Report on

**Review of Special Auditing Function of  
NSW Auditor-General's Office**



Report No 70

June 1993

Parliament of New South Wales

Public Accounts Committee

of the

Fiftieth Parliament

Report on

**Review of Special Auditing Function  
of NSW Auditor-General's Office**

**Seventieth Report**

Inquiry pursuant to Section 57(1) of the Public Finance and Audit Act 1983. (Minutes of Evidence are printed in a separate volume to this Report)

June 1993

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**REPORT ON  
REVIEW OF SPECIAL AUDITING FUNCTION  
OF NSW AUDITOR-GENERAL'S OFFICE**



From left:  
Ray Chappell (Vice-Chairman), Terry Rumble, Andrew Tink (Chairman), Ian Glachan, Geoff Irwin

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## The Public Accounts Committee of the 50th Parliament

The Public Accounts Committee of the 50th Parliament comprises three Government and two Opposition members. A chairman and vice-chairman are elected by the Members.

### **Mr Andrew Tink, BA, LLB, MP, Chairman**

Before becoming Liberal Member for Eastwood in March 1988, Andrew Tink practised as a barrister in equity, commercial and shipping law. He has since served on numerous parliamentary and government committees, holding the position of Chairman of the Joint Committee on the Office of the Ombudsman prior to his appointment to the Public Accounts Committee. He is also a Temporary Chairman of Committees in the Legislative Assembly and its representative on the Macquarie University Council.

### **Mr Ray Chappell, MP, Vice-Chairman**

Ray Chappell was elected National Party Member for Northern Tablelands in May 1987. He has worked in university administration and in the building and retail industries, and he served four terms as an alderman on Armidale City Council. Ray Chappell is the Legislative Assembly representative on the Board of Governors of the University of New England, and is a Temporary Chairman of Committees in the Legislative Assembly.

### **Mr Geoff Irwin, ProdEngCert, DipTech, DipEd, MP**

Geoff Irwin was elected to Parliament in March 1984 as the Labor Member for Merrylands, and he has been the Member for Fairfield since March 1988. Before entering Parliament he worked in industry as a planning and supply manager and taught business studies at TAFE. He served as a member of the Select Committee upon Small Business and as Opposition Spokesperson on Business and Consumer Affairs.

### **Mr Terry Rumble, ASA, MP**

Terry Rumble was elected Labor Member for Illawarra in March 1988. Before entering Parliament he qualified as an accountant and was employed in public practice and in the coal mining industry. He has served as a member of the Regulation Review Committee and is the Chairman of the Opposition's Backbench Committee which involves Treasury, arts and ethnic affairs.

### **Mr Ian Glachan, MP**

The Liberal Member for Albury since 1988, Ian Glachan has had a varied background. He served five years at sea as a marine engineer, was a farmer for ten years, and operated a newsagency in Albury for 18 years. Mr Glachan is also a past president of the Albury-Hume Rotary Club, an active member of the Anglican Church, and the Legislative Assembly member on the Board of Governors of Charles Sturt University.

## CHAIRMAN'S FOREWORD

This report is a follow-up to part of Report No. 49 dealing with the Auditor-General's Office.

Recommendations from that earlier Report included giving the Auditor-General a power to conduct special audits and a sum of \$1,000,000 to fund the development work required for the Auditor-General to move towards a comprehensive audit approach.

This report arises out of the Committee's further recommendation, that the method and level of recurrent funding and progress achieved in moving towards comprehensive auditing be reviewed after 2 years.

To help conduct this review, the Committee retained Arthur Andersen and their contribution forms Part 2 of this report.

Part 1 is the Committee's overview which draws on the evidence and Arthur Andersen's contribution to highlight issues which the Committee thinks should be brought to the specific attention of Parliament and these are reflected in the findings and recommendations.

In short, the Committee is concerned that notwithstanding the Auditor-General's written claim that he has "conducted 3 special audits in terms of the Act", this is not so and was later conceded by him in evidence. In particular, the Auditor-General needs to give much greater emphasis to the question of effectiveness in such audits.

The Committee believes that the Auditor-General should carry out special audits which specifically address the question of effectiveness as a primary audit objective. Indeed the importance of effectiveness is stressed in the Auditor-General's own manual.

No change should be contemplated to the legislation until a special audit which pays due regard to each of economy, efficiency and effectiveness has been carried out by the Auditor-General's Office.

The Committee recommends that Treasury provide \$1,000,000 to the Auditor-General for each of the next 2 years which should be specifically for the purpose of conducting special audits incorporating each of economy, efficiency and effectiveness in lieu of the Auditor-General's request for further funding over 4 years.

The Committee should further review progress and the Auditor-General's powers to conduct special audits in 2 years' time.

I would like to thank Arthur Andersen for their very professional approach to this task and all witnesses who assisted in giving evidence, not least the Auditor-General and his officers who have, notwithstanding our criticism in this report our full support and respect.

Finally, I would like to thank the Public Accounts Committee staff and my Committee members who in the tradition of the Committee, have approached this Inquiry in a bipartisan way and agreed on this Report unanimously.



Andrew Tink MP  
Chairman

## TERMS OF REFERENCE

To review:

1. The method and level of recurrent funding for performance auditing.
2. Progress achieved in moving toward comprehensive auditing, including
  - setting of budgets for individual projects
  - level, cost and quality of resources for special audits
  - appropriateness of methods of investigation and report preparation
  - training in special audits
3. The objectives and results of performance work already carried out, including
  - criteria for selection of special audit projects
  - formal responses by relevant Ministers
  - promised and actual action by departments
4. The Auditor-General's proposals for future funding of performance auditing.

## FINDINGS AND RECOMMENDATIONS

1. Whatever the background was to the Auditor-General getting a statutory power to conduct special audits, the intent of the legislation on its face is clear: that special audits must consider economy, efficiency, effectiveness and compliance with all relevant laws.
2. Notwithstanding the Auditor-General's written claim that he had "conducted three Special Audits in terms of the Act", this is not so and was later conceded by him in evidence.
3. Auditee comment was particularly critical that the Auditor-General did not fully consider the question of effectiveness; an observation also made by Arthur Andersen and acknowledged by the Auditor-General in evidence.
4. The Auditor-General's special audit manual specifically stresses the importance of considering effectiveness as a primary issue, nominating it as "arguably the most important element of performance auditing".
5. Had the manual been more fully developed prior to the special audits being undertaken, with greater emphasis placed on effectiveness, better results might well have been obtained.
6. Until the Auditor-General carries out a special audit in the nature of a performance audit which gives due weight to each of economy, efficiency and effectiveness, the Committee is not in a position to pass a final opinion on the worth of such an exercise.

## *Special Audits Review*

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7. What the Committee finds most significant is that effectiveness which has been nominated by the Auditor-General as arguably the most important element of performance auditing, has yet to be fully considered in any "special audit" carried out by him. In that regard, the Committee believes that effectiveness should be fully considered in a special audit before the final opinion referred to in paragraph 6 is made.
8. However the Committee accepts the advice of Arthur Andersen that a special audit should not have to encompass a consideration of compliance with all relevant laws except to the extent that compliance may relate to economy, efficiency and effectiveness.
9. In these circumstances, the Committee recommends that the Treasury provide \$1,000,000 to the Auditor-General for each of the next two years specifically for the purpose of conducting special audits incorporating each of economy, efficiency and effectiveness, in lieu of the \$6,000,000 over four years sought by the Auditor-General.
10. Consideration of any legislative amendments to the special audit powers should be deferred for two years, and the method and quantum of further funding reconsidered at that time.
11. Whilst the Committee accepts unreservedly the commitment and professionalism of the Auditor-General's office and the fundamentally important work it carries out in the public interest, the Committee believes that it must be robust in following through on issues of significance where \$1,000,000 has been provided to the Auditor-General by Treasury to fund development work required for the Auditor-General to move towards a comprehensive audit approach.

## **PART 1: COMMITTEE OVERVIEW OF AREAS OF PARTICULAR CONCERN**

### **SPECIAL AUDITS**

This review of the Auditor-General's special audit function is in two parts. This part comprises the report and recommendations of the Committee which draw heavily on the second part, which is the report of the Committee's consultants Arthur Andersen.

In a major report on the Auditor-General's Office tabled in Parliament in July 1990, the Public Accounts Committee strongly favoured a clear legislative mandate and approach to audit in New South Wales which would encompass:

- i. the examination and expression of an opinion of the financial statements;
- ii. reviewing and reporting on compliance with laws, regulations and administrative controls relating to expenditure and overall financial management;
- iii. examining and reporting on the efficiency and economy of operations and the effectiveness in achieving program objectives.

In the report, the Committee went on to say that its proposal for giving the Auditor-General a comprehensive auditing power involved an approach which embraces all three of these elements, that is:

- attestation of financial statements
- checking compliance with legal and administrative regulations; and

*Public Accounts Committee*

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- assessment of the economy, efficiency and effectiveness of auditee operations.

The formal recommendations of the Committee put forward two changes to the Public Finance and Audit Act. So far as is relevant, the first related to amendments which would create a new section 34(2) authorising the Auditor-General to examine, amongst other matters, "the economy, efficiency and effectiveness which any department, authority or other body . . . has individually or in association acquired or used its resources in discharging its functions".

Another recommendation suggested adding subclause 4 to Section 52 to the effect that "the Auditor-General may report on any cases in which he has observed that resources have been used without due regard to economy, efficiency or effectiveness".

In general terms, the Committee suggested a flexible approach, but this was clearly not taken up by Parliament in the amending Act.

Thus, the Public Finance and Audit Act was amended in 1992 to provide the following special audit power in Section 38B subsection (1) of the Act:

"38B. (1) The Auditor-General may, when the Auditor-General considers it appropriate to do so, conduct an audit of all or any particular activities of an authority to determine whether the authority is carrying out those activities effectively and doing so economically and efficiently and in compliance with all relevant laws.

(2) A special audit is separate from, and does not affect, any other audit required or authorised by or under this Act or any other Act."

The PAC's recommendations concerning Sections 34 and 52 referred to earlier were not followed and the Act (Section 38) specifically defined special audits as incorporating both performance auditing covering economy, efficiency and effectiveness, and compliance auditing.

The PAC further recommended that Parliament provide the audit office with a special allocation of \$500,000 in each of the next two years from 1990 to fund the development work required for the Auditor-General to move towards a comprehensive audit approach. This funding was subsequently provided to the Auditor-General by Treasury.

Finally, the Public Accounts Committee recommended that the method and level of recurrent funding for performance auditing by the Auditor-General be examined two years after the implementation of the first stage of the move towards comprehensive auditing, and that the progress achieved in moving towards comprehensive auditing and the objectives and results of performance work carried out during that period be reviewed with firm proposals for recurrent funding of performance auditing being put forward by the Auditor-General.

On 4 February 1993 the Auditor-General wrote to the Chairman of the Public Accounts Committee enclosing a report addressing itself to the progress achieved in moving towards comprehensive auditing. The report also detailed the objectives and results of performance work carried out and suggested firm proposals for further recurrent funding.

In his letter the Auditor-General said:

"The Office has carried out a performance audit at the Department of Housing. This was followed by three special audits in terms of the Act and a number of fact-finding examinations which have been called Special Reviews."

Pausing here, it is interesting to note that the Department of Housing performance audit so described by the Auditor-General is not properly described by those words.

The Committee agrees with its consultants Arthur Andersen that the scope of the audit was different from that of a true performance audit, involving, as it did, a review of the administration of over 40 specific public housing and construction projects with the aim

of determining what overall conclusions could be drawn as to the manner in which the Department of Housing administers housing schemes and manages construction projects. The consultants state specifically that the scope of that audit was:

" . . . quite different to that of a performance audit having no specific focus on economy, efficiency and effectiveness."

Moreover, to quote Arthur Andersen on the question of special reviews:

"It is clear from the description of special reviews that they are not audits of the type contemplated by Section 38B(1)."

In any event, in his submission, the Auditor-General sought a total of \$6,000,000 over the next four years to provide future funding for his special audit function.

Following receipt of the Auditor-General's correspondence and submission, the Committee resolved in consultation with the Auditor-General to seek by way of public advertisements expressions of interest from suitably qualified parties to be involved in the review.

After considering a number of very high quality submissions, the Committee resolved to select Arthur Andersen as consultants to assist it in the review. Its decision was based in particular on Arthur Andersen's experience in similar very successful reviews of the Victorian Auditor-General's Office. Arthur Andersen's costs were agreed to be paid by the auditee on the usual basis.

After further deliberations, it was decided to set up an Advisory Committee comprising representatives of the Commonwealth Auditor-General's Office, the Victorian Auditor-General's Office and an academic accounting representative from the University of Technology. These representatives subsequently attended meetings with the consultants and Committee members to provide advice on the scope and nature of the review.

## *Special Audits Review*

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The Public Accounts Committee further resolved to conduct public hearings on two separate days. On the first day, evidence would be taken from a number of auditees who had been subject to special audits by the Auditor-General, and on the second day, the Auditor-General and his senior staff who had been involved in carrying out those special audits.

Arthur Andersen then prepared a draft report of their own which was circulated to Public Accounts Committee members and discussed at some length. In its final form, it is a most important part of this report to Parliament.

There are a number of issues that the Committee wishes to specifically draw to the attention of Parliament which were of concern to it in relation to the review process.

The first and foremost of these is the threshold question of whether or not the Auditor-General has yet conducted a special audit under the provisions of the Public Finance and Audit Act.

It must be said that this was an issue which was uppermost in the minds of the auditees, many of whom vigorously asserted that no such special audit had been carried out.

In terms of the Act, a special audit must look at economy, efficiency, effectiveness and compliance with all relevant laws. A plain reading of S. 38 of the Act puts the necessity of covering all those elements beyond doubt.

In evidence on 3 June 1993 the following exchange took place between the PAC Chairman and the Auditor-General:

**CHAIRMAN:** In your letter to me earlier this year requesting funding for the future you said that the office had done three special audits in terms of the Act. That is not in fact the case?

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**AUDITOR-GENERAL:** I can see the argument. It says that if you have to do effectiveness, efficiency, economy and compliance, we have not. I concede that."

It is also plainly the view of Arthur Andersen, as can be seen from their attached report, that the Auditor-General has not, contrary to his claim in his correspondence, yet done a special audit within the meaning of the Act. To quote Arthur Andersen:

"... it remains the case that the Office has yet to undertake a special audit embracing all of the section 38B(1) mandate".

Whilst the Auditor-General has done many special reviews which are useful exercises in the public interest, he has had the power to do these for some time pursuant to powers vested in him by statute which have nothing to do with his special audit power. To quote Arthur Andersen:

". . . they (special reviews) do appear to derive more from the Auditor-General's right under Section 52(3) to report on matters arising from his regular auditing activity than to arise from his Section 38B(1) mandate."

Moreover the three audits which the Auditor-General identifies as special audits done pursuant to this new special audit power each lack one or more of the key statutory elements.

In these circumstances, the Committee has concluded that the Auditor-General has yet to do a special audit within the meaning of the Act for which purpose \$1,000,000 was paid to his office over the last two years to fund the development work required.

The single largest "special audit" to date is the Disciplined Services Training Special Audit which has so far cost \$376,000 but which is not yet entirely complete.

Evidence and written responses from auditees strongly assert that totally insufficient

attention was paid by the auditors to the question of effectiveness. Evidence from the head of the Corrective Services Department, Major -General Smethurst given to the Committee on 24 May 1993 is instructive:

**MAJOR-GENERAL SMETHURST:** . . . "If I could make some comment on the audit approach. Firstly, I would say it was very predominantly financially orientated. In other words, it appears to us anyway to be very much a money chasing exercise with very little weight given to the non-quantifiable but I think, very significant cultural issues . . .".

In a written response to the same audit, the Police Commissioner, Mr Lauer, made a number of comments included the following:

"The audit report is narrowly based and primarily focussed on economic measures with little or no attention paid to effectiveness.

This final version of the report does not substantially address issues of educational management, efficiency and effectiveness nor does it take account of professional (or occupational) organisational accountability differences between the services.

It is quite unacceptable for the future development of the Police, Corrective Services and Ambulance to be affected by the decisions taken on a partial analysis of their educational and training requirements.

This legislation [the Public Finance and Audit (Auditor-General) Amendment Bill 1991 Section 38B(1)] obviously requires that the scope of special audits embrace both efficiency and effectiveness..."

In more general terms, Commissioner Lauer summarised his concerns as follows:

"It is clear from the report that the auditors concentrated on interpretation of economic activities which gives inadequate attention to the effectiveness particular with regards to the implications of the audit findings.. .

In several critical areas the audit report is methodologically flawed. The report concentrates almost exclusively on the need to extract a cash return on Sydney property assets when it should be addressing the impact on the organisational effectiveness of the respective services . . . .".

Issues raised by these criticisms were also of concern to Arthur Andersen who made the following comments in relation to the Disciplined Services audit:

"Audit . . . took a pro-active approach to solving the problem by developing options and in effect 'pricing them' ".

"The latter step is very unusual in performance auditing and one which causes us some discomfort."

Further on Arthur Andersen state:

". . . as a matter of principle we do not think an audit should be involved in the detailed identification, development, costing and selection of potential courses of action. It is absolutely fundamental to the audit function that audit examines, evaluates and reports on the processes of the executive. To be able to do so audit must remain outside those processes."

Elsewhere in their report, Arthur Andersen put it this way:

"The function of the Auditor-General is to provide an objective, independent review of the processes of administration in the public sector and of the outcomes of those processes. It therefore follows that the Auditor-General must remain outside these processes. To participate in them results in a loss of independence and therefore compromises the very nature of the audit functions.

In our review of the Disciplined Services Stream 1 audit, we express concern that the Auditor-General may, for well-intentioned reasons have gone somewhat beyond the appropriate boundaries of the audit function on this occasion."

Some of the key thrusts of Commissioner Lauer's concerns and the unease expressed by others in evidence was conceded by the Auditor-General in the following evidence given to the Chairman:

**CHAIRMAN:** "What Commissioner Lauer said in his response on that audit and what the Police who came to see the Committee the other day said was that they saw the starting point of the audit as being something driven by an asset realisation.

**AUDITOR-GENERAL:** I think that is right - not so much an asset realisation as an efficiency issue. I think that is right that there was spare capabilities in a number of institutions and some plans to extend them.

**CHAIRMAN:** In the context of considerations relating to effectiveness, though they were things that were flagged by the auditees as being important issues, the audit proceeded on the efficiency question. It proceeded on the assets sale aspect.

**AUDITOR-GENERAL:** Yes."

Whilst effectiveness was looked at to some extent during the Disciplined Services Audit, it does appear to have occurred very much after the fact with the audit being driven by a predisposition on the part of the auditors towards an asset realisation program.

What this means and what is very graphically illustrated from the auditees' responses is that the audit was concentrating far too much on efficiency and not enough on effectiveness. This in turn had a major impact on the reaction to the audit on its completion.

In particular, the Police Commissioner drew specific attention to the Legislative mandate which requires effectiveness to be weighted in against economy and efficiency. To the extent that this was not done in the Disciplined Services audit, the Committee believes that it has had a negative impact on the outcome.

What this illustrates is the need to provide some balance in special audits between the so-

called "three e's", economy, efficiency and effectiveness.

Ironically, this very point is stressed in the Audit Office's own manual developed specifically for special audits which at page 18 makes the following point:

"Effectiveness is arguably the most important element of performance auditing. Goods or services may be provided economically and efficiently but if they don't achieve their intended outcomes the resources used will be largely wasted."

Indeed Arthur Andersen state:

"Further the way in which Section 38B(1) has been drafted appears to give primacy to the effectiveness element of performance auditing."

Whilst the auditees may have a vested interest in over-emphasising the effectiveness argument in the disciplined services audit, it is impossible to escape the impression that the emphasis placed on effectiveness in the manual was not forthcoming in practice in this particular audit.

No doubt part of the reason for this was that the audit was undertaken before the manual was developed and the Committee cannot escape the conclusion that, had the manual been developed before the audit was undertaken, the result would probably have been different.

Unfortunately this problem was not limited to the Disciplined Services Special Audit. To quote Arthur Andersen:

"It will be evident from the detailed reviews of the four special audits undertaken to date that they are not "special audits" in the terms identified above. They clearly incorporate significant elements of a performance audit but they do not encompass all elements. In particular, they have not focussed on effectiveness as a primary audit objective."

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The Cost of these "special audits" is as follows:

Audit	Hours	Fees
Public Housing Construction	3,576	\$365,000
Disciplined Services Training - Stream 1	3,051	\$376,000
Public Servant Rental Housing	1,111	\$119,000
Police Air Travel	436	\$ 72,000
	<hr/> <hr/> 8,174	<hr/> <hr/> \$932,000

The Committee also made special note of Arthur Andersen's finding that:

"Clearly the special audits mentioned do not conform entirely to the methodology or standards established in the Office's performing auditing manual. This reflects in large part the fact the development of the manual has taken place over the same period of time that the special audits have been performed."

In the Committee's view, it would have made much more sense if the development of the audit manual had been made a priority and the special funding used to develop it to a greater extent before the special audits were undertaken. This would have avoided some of the major problems identified by Arthur Andersen and the auditees in each of the audits.

The cost of developing the manual was \$147,000.

What emerges from all this is the importance of having a balanced approach to special audits where significant consideration is given to each of effectiveness, economy and efficiency. Indeed as the audit manual itself states, if primary emphasis is to be given, it should be on effectiveness.

Although it was put to the Committee that the nature of section 38B(1) might be too draconian in requiring each of these elements to be considered at length and might be more prescriptive than the Committee originally intended, the Committee nevertheless feels that it is important to pursue the goal of a special audit incorporating each of these elements and notes that the Auditor-General's Office has yet to produce one.

To put it in a nutshell, the Committee believes that unless and until it has seen a special audit of the type contemplated by the Act, it is not in a position to determine whether or not the Act needs amending.

What the Committee finds most significant is that effectiveness which has been nominated by the Auditor-General as arguably the most important element of performance auditing has yet to be fully considered in any "special audit" carried out by him. In that regard, the Committee believes that effectiveness should be fully considered in a special audit before the final determination referred to in the above paragraph is made.

In these circumstances, the Committee believes that the goal of conducting special audits incorporating the three "e's" as currently defined by the Act is worth pursuing and does

not believe at this stage that a recommendation to change the legislation is appropriate.

At the same time the Committee has considered and accepts the advice of the consultants that the need to require the Auditor-General to pro-actively consider the question of compliance with all relevant laws in every special audit that he carries out is cumbersome, time-consuming and not necessary but for the fact that the Act requires it.

Given that the Auditor-General is yet to carry out a special audit within the terms of the Act, the Committee does not believe that his request for \$6,000,000 funding over the next four years should be granted at this stage.

In these circumstances, the Committee proposes to recommend to Treasury that funding of \$1,000,000 per year for the each of next two years be provided to the Auditor-General's Office specifically to carry out special audits incorporating the three "e's" within the meaning of the Act but not compliance except as it may relate to economy, efficiency and effectiveness.

In this sense, the Committee is recommending that further funding be provided to do special audits which are performance audits rather than performance and compliance audits.

The funding should be provided by Treasury specifically on the basis that it does cover projects which will in a pro-active sense from the outset cover economy, efficiency and

effectiveness.

Indeed the Committee believes that the Auditor-General and the audit teams should make a greater effort than in the past to clearly articulate to the auditees the objectives of the audit in each one of the "three e" categories.

Feedback from the auditees during the hearings has suggested that the failure of the auditors to articulate objectives has meant that the auditees have not been able to work as effectively with the auditor as they would have been had they better understood or had explained to them the objectives of the audit. To quote Arthur Andersen:

"There was broad consensus expressed by auditees that the nature, scope and objectives of the special audits had not been articulated clearly to them. The resultant lack of understanding of the audits by auditees inhibited their ability to work with the auditors to achieve an efficient and effective audit.

It is clearly to the benefit of both the auditor and the auditee that the audit is undertaken in as co-operative and consultative a manner as is consistent with the independence of the audit function".

It should be noted that the funding assessment of \$1,000,000 a year over the next 2 years is a revised assessment by the Auditor-General of his financial position in conjunction with input from Arthur Andersen. In that regard, the \$1,000,000 figure proposed over the each of the next two years is limited in the Committee's view solely in

terms of time rather than quantum because the quantum is solely based on the revised assessment referred to above.

The other major issue considered by the Committee to require comment is the question of appropriation of funds for special audits. Whatever be the position down the track concerning Parliamentary appropriations, the Committee believes that for the next two years at least the funding of special audits should continue to be made by the Treasury based on the Committee's specific recommendations, and that the inter-face between Parliament and the Executive in the provision of funds be on that basis.

At the end of that time, the Committee should undertake a further review of work carried out by the Auditor-General's Office on special audits with a view to determining the method of future levels of funding for special audits and whether or not the legislation requires amendment. Again, the Committee notes Arthur Andersen's comment:

"The PAC may consider it to be beneficial to undertake a further review of the section 38B mandate after some special audits have been completed which encompass all the elements contemplated by that section of the Audit Act (except perhaps, compliance with all relevant laws)."

The Committee would not want it thought that work done by the Auditor-General which does not fall within the definition of special audits is of no value. On the contrary, the special reviews carried out by the Auditor-General are extremely important projects

executed in the public interest as indeed are his other functions under the Act.

What is of fundamental importance to the Committee in this Inquiry is that a specific sum of money was recommended to fund the development of a comprehensive audit approach. Notwithstanding the Auditor-General's provisional view that he carried out three special audits in terms of the Act this is in fact not the case and is a proper matter for comment by the Committee.

Where money is provided for a specific purpose and the PAC has an oversight role in ensuring that that money is spent for the purpose for which it was provided, then we do believe it is relevant, appropriate and indeed important for us to comment in this way. That is why the Committee's recommendations in this report are tailored around a further probationary grant of money to in fact ensure that a special audit incorporating the three "e's" within the meaning of the Act is executed in a proper and balanced format.

## **PART 2: REVIEW OF THE SPECIAL AUDITING FUNCTION OF THE NEW SOUTH WALES AUDITOR-GENERAL'S OFFICE**

### **1. OVERVIEW**

In 1992, amendments were enacted to the Public Finance and Audit Act 1983 ("the Audit Act"). The Audit Act is the principal legislation defining the powers and responsibilities of the Auditor-General.

One of the principal changes to the Audit Act effected by the 1992 amendments was to allow the Auditor-General to undertake "special audits". A "special audit" was defined as:

*"an audit of all or any particular activities of an authority to determine whether the authority is carrying out these activities effectively and doing so economically and efficiently and in compliance with all relevant laws." (Section 38B(1)).*

An examination of the economy, efficiency and effectiveness of activities is generally described as a "performance audit." Where an auditor has the authority to conduct performance audits, audits of financial statements ("financial audits") and audits of compliance with laws and regulations ("compliance audits"), the auditor is said to have a "comprehensive auditing" mandate.

The effect of Section 38B(1) was to give the Auditor-General a comprehensive auditing mandate by adding a performance audit authority to the existing financial and compliance audit authorities. A "special audit" as defined by Section 38B(1) encompasses both a performance audit and a compliance audit.

Because the Auditor-General had not previously undertaken performance audits, he was provided with \$500,000 of funding in each of the 1991/92 and 1992/93 years to develop a performance audit capability.

The objectives of this review are to consider:

1. The progress achieved in moving towards comprehensive auditing, and the objectives and results of performance audit work carried out in that period; and
2. The method and level of recurrent funding for performance auditing.

The overall conclusion reached is that the Auditor-General has made significant progress in developing the performance auditing capability of The Office of the Auditor-General ("The Office").

A group of specialist performance auditors with appropriate skills and experience has been established, and a high quality performance auditing manual has been prepared.

The Office has undertaken a number of audits which involve significant elements of performance auditing, but has yet to undertake an audit which encompasses both a compliance audit and all elements of performance auditing.

Some significant uncertainties have been identified as to precisely what is the scope of the "special audit" mandate which the Auditor-General now has. On the face of it, Section 38B(1) appears to require that a special audit encompasses all the four elements of economy, efficiency, effectiveness and compliance. It is open to question as to whether such a restrictive mandate is either desirable or consistent with the intention of the legislation. These uncertainties need to be resolved, as they are directly relevant to the questions of whether the Auditor-General is meeting his mandate, and upon what basis the Office should receive special funding in the future.

*Special Audits Review*

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The Office has done the work necessary to enable it to proceed to full performance auditing. The detailed observations and recommendations made in this report are intended to assist in this process.

## **2. SUMMARY OF OBSERVATIONS**

### **1. Development of Performance Auditing Capability**

The Office established a Special Branch, currently comprising eight professionals, which was dedicated to the development of the Office's performance auditing capability by developing an appropriate methodology and by undertaking audits in response to the enhanced mandate.

In the short-term, it is sensible to concentrate performance audit skills in a specialist group. In the longer term, it would be expected that a significant proportion of the Office's audit staff will develop the skills necessary to undertake (or, at least, identify prospective issues for) performance audits.

The individual auditors in the Special Branch demonstrate the required mix of skills and attributes for performance auditing. If the Office expands its performance auditing capacity by external recruiting, it should look beyond the traditional qualifications of financial auditors in identifying suitable candidates.

The performance auditing manual, which has been developed to final draft stage, is a very high quality product which should provide a solid framework for the successful execution of quality performance audits.

The Office will need to further develop the formal training component of the continued development and maintenance of performance audit skills.

### **2. Special Engagements Performed**

The Office has undertaken a number of engagements over the past two years which are not attest audits of financial statements. These are referred to as "special reviews" and

"special audits".

"Special reviews" are essentially fact-gathering exercises. They are not audits of the type contemplated by Section 38B(1). These reviews fulfill a useful purpose, and an examination of two special reviews established that the resultant reports were supported by sufficient appropriate audit evidence.

However, they are exercises of a type which the Auditor-General had undertaken prior to the amendments to the Audit Act (as a means, we understand, of demonstrating the benefits of a more comprehensive reporting mandate), and do not conform to the Section 38B(1) mandate. They are, therefore, arguably outside the scope of the activities for which special funding was provided.

The Office has undertaken four "special audits":

- o Public Housing Construction - Selected Management Issues (undertaken prior to the enactment of the amendments to the Audit Act)
- o Training and Development for the State's Disciplined Services:  
Stream 1 - Training Facilities
- o Rental and Management Aspects of Public Servant Housing
- o The NSW Police Service - Air Travel Arrangements.

The four audits are all very different in scope, and none of them comprises all elements of a performance and compliance audit. The wording of Section 38B(1) seems to contemplate only engagements which cover all of economy, efficiency and effectiveness, as well as compliance with legislation.

The scope of audits permitted or required by Section 38B(1) should be clarified before future funding levels are determined.

The following observations arose from review of the four special audits:

i) Quality of Work

The Office is very thorough and disciplined in accumulating the audit evidence needed to support the finding of facts contained in the reports. Appropriate levels of consultation occur within the Office on significant judgemental issues.

As no audits which address all of the elements of a Section 38B(1) special audit have yet been performed, there may be some merit in undertaking a further review in the near future.

ii) Selection of Audits

The Office should seek to draw on all available resources, including audit staff, auditees and Parliament, in identifying the special audit subjects which are most likely to result in benefit to the State. The Office has recognised and responded to this opportunity.

The Auditor-General must retain the sole right to select special audits.

iii) Communication with Auditees

Feedback from auditees determined that there had not been effective communication of the scope, objectives and criteria of the special audits. The Office has taken steps to address this issue.

iv) Decisions to Proceed with Audits

The special audits were structured with appropriate checkpoints to ensure that there were sufficiently significant issues emerging to make continuation of the audit worthwhile.

In the Disciplined Services audit, whilst significant issues were emerging, it also became evident that all affected auditees were extremely resistant to those remedies examined by the auditors which involved collocation of training facilities. Whilst one of the relevant Ministers supported the basic premise of the collocation options, the opposition of the other relevant Minister and the affected Services made it highly unlikely that any of the suggested collocation options would be implemented.

In such circumstances, it may not be cost-effective for the audit team to pursue a detailed evaluation of options for improvement. The Office's accountability responsibilities had been met by identifying the issue and outlining feasible alternative approaches.

v) Auditing or Participating In Processes

The Disciplined Services report went into considerable detail in analysing the costs and benefits of possible alternative arrangements, and identified one as being the most cost-effective.

Whilst this was done with the best of intentions to demonstrate the efficacy of potential changes to operations, it was in our view inconsistent with the audit function. The Auditor-General has to remain outside of the processes which lead to decisions of the Executive. The work which the auditors undertook in costing out alternatives was work which should, in our view, properly have formed part of the process of deciding how to respond to the issue which the audit report had identified.

### **3. Financial Analysis**

The Office has spent \$2.6 million on special audits and reviews, and on administration of the Special Branch. As only \$1 million of special funding was provided, it follows that the balance was in effect funded out of revenues received for financial audits.

The Office incurred 975 hours and costs of \$147,000 in developing the performance audit manual. \$13,700 has been spent on additional equipment and \$9,000 on the use of external consultants.

The annual cost of maintaining the Special Branch at its current level is approximately \$1,000,000.

The proportion of total Office resources devoted to special audits and reviews has increased from 3.5% in 1989/90 to an average of 7% in 1990/91 and 1991/92.

### **4. Forward Funding Requests**

The Auditor-General's submission assumes that all special audits and reviews will be specially funded, and that the proportion of Office resources applied to this function will increase progressively to 20% by 1996.

In a later letter to the Treasury, the Auditor-General indicated that he would be able to internally resource up to \$1 million of the necessary funding. With planned expenditure of \$1.68 million in the year ended 30 June 1994, the Auditor-General indicated to the Treasury that this suggests a Treasury provision of \$0.75 million for the 1993/4 fiscal year. Based on subsequent internal funding of \$1 million per annum, there would be a need for Treasury appropriations to rise progressively to approximately \$2 million by the 1996/7 fiscal year.

Consideration needs to be given to whether authority to approve the Office's budget should lie with Parliament or with the Executive, and whether a mechanism should be put in place to determine future annual funding levels or whether the matter should be reconsidered each year.

### **3. SCOPE OF THE REVIEW**

#### **3.1 Background to the Granting of the Special Audit Mandate**

##### *Previous Legislative Mandate*

The traditional function of an Auditor-General, both in Australia and overseas, has been to conduct audits of the financial accounts of public sector entities and to report to Parliament on the results of these audits.

The principal legislation establishing and defining the responsibilities of the New South Wales Auditor-General is the Public Finance and Audit Act 1983 ("the Audit Act").

Section 34 of the Audit Act defines the duty of the Auditor-General as follows:

"The Auditor-General shall audit the Public Accounts and such other accounts as the Auditor-General is authorised or required to audit in such manner as the Auditor-General thinks fit having regard to the character and effectiveness of the relevant internal control and recognised professional standards and practices".

Reporting obligations are imposed on the Auditor-General by Section 43(2) (reports on audits of statutory bodies to be provided to the statutory body, to the Minister and to the Treasurer) and by Section 52(1) (report on the Public Accounts to be presented to the Legislative Assembly).

Section 52(3) permits the Auditor-General, either in Section 52(1) report or in a "special report", to:

"recommend any plans and make any suggestions for the better collection and payment of public money ... and may generally report on any matter arising from audit which in the opinion of the Auditor-General should be brought to the attention of Parliament."

Consequently, the functions of the Auditor-General under the original provisions of the Audit Act were confined largely to the audit of the financial statements of public sector entities, and the reporting to Parliament of matters of significance arising therefrom.

*Public Accounts Committee Report No. 49*

Whilst the scope of responsibility of the Auditor-General described above was consistent with that which initially had been established elsewhere, by the mid-to-late 1980's New South Wales was lagging behind other public audit offices in the development of a more comprehensive mandate.

Both within Australia (for example, the Federal and Victorian audit offices) and internationally (for example, Canada, the United Kingdom and New Zealand) the role of the Auditor-General had been expanded to accommodate a mandate to examine the manner in which the various units of the Public Sector operate. There were some differences between mandates, but all dealt with the examination of some aspect of the efficiency, effectiveness or value-for-money performance of auditees.

In New South Wales, the Auditor-General in 1989 expressed the opinion that:

"I am becoming increasingly concerned that I am fulfilling neither Parliament's expectations nor the modern role of an Auditor-General."

There were two principal constraints on the ability of the Auditor-General to expand the scope of his work in the then-current circumstances. Firstly, there were differing views as to whether the provisions of the Audit Act permitted him to do more than undertake financial audits and comment on issues arising from those audits. Secondly, because the Office had been taken "off-budget" in July 1988 (that is, the Office was to be self-funded by charging for services rendered, rather than being funded by appropriation), it was

unclear as to how the Office was to fund an expanded scope of activity.

In response to the above concerns, the Public Accounts Committee of the Parliament ("PAC") undertook an examination between October 1989 and March 1990 of the functions of the Auditor-General.

That review resulted in the release in July 1990 of PAC Report No. 49, "Report on the New South Wales Auditor-General's Office." Significant recommendations made in Report 49 are reproduced at Appendix 1.

#### *Amendments to the Audit Act*

In response to Report No. 49, a number of amendments were made to the Audit Act. The principal changes were:

1. The addition of Division 2A (Sections 38A-38E) (refer Appendix 2 for details).

In summary, Section 38B(1) empowered the Auditor-General to conduct "special audits", which were defined as:

"audit(s) of all or any particular activities of an authority to determine whether the authority is carrying out those activities effectively and doing so economically and efficiently and in compliance with all relevant laws."

Section 38D provided that in undertaking such an audit, the Auditor-General was precluded from questioning the merits of Government policy objectives.

In this report, the term "special audit" is used to describe an audit as defined by Section 38B(1) of the Audit Act.

2. The provision in Section 48A for a triennial review of the Auditor-General's office to:

"examine the auditing practices and standards of the Auditor-General and to determine whether the Auditor-General is complying with those practices and standards in the carrying out of the Auditor-General's function under this Act."

These amendments to the Audit Act were proclaimed in March 1992.

### *Provision of Special Funding*

The Auditor-General had undertaken certain reviews in earlier years which encompassed some aspects of the activities now permitted by Section 38B(1) with the objective, we understand, of demonstrating to Parliament the benefits available from more comprehensive reporting. However, the Office had not undertaken any performance audits, and did not have the capacity (in terms of skills, personnel or methodology) to do so immediately.

Consequently, Recommendation 19 of Report 49 recommended the provision of \$500,000 per year for two years "to fund the development work required for the Auditor-General to move toward a comprehensive audit approach". This money was described in the Report as "seed funding".

Parliament adopted this recommendation and provided the Auditor-General with \$500,000 in each of the 1991/92 and 1992/93 financial years to develop a performance audit capability.

### **3.2 Terms of Reference of The Current Review**

Recommendation 20 of Report No. 49 provided that at the end of the initial two year development period, a review be undertaken of:

1. The progress achieved in moving towards comprehensive auditing, and the objectives and results of performance audit work carried out in that period; and
2. The method and level of recurrent funding for performance auditing.

It was also recommended that the Auditor-General put forward firm proposals for the recurrent funding of performance audits. The Auditor-General's submission is included as Appendix 5.

The current PAC have followed the recommendation of Report No. 49 and, after a process of advertising and evaluation of proposals, appointed Arthur Andersen to assist in the conduct of the review. The terms of engagement are attached at Appendix 4.

### **3.3 Scope and Approach to the Review**

The review addresses two issues:

1. What has been achieved in the two years since the expansion of the mandate and the provision of special funding?
2. What observations and recommendations can be made on the proposed future direction of the performance audit function, including funding arrangements?

The three main initiatives undertaken by the Office in the last two years are:

### *Special Audits Review*

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- i) The establishment and staffing of a Special Branch, dedicated to non-financial auditing.
- ii) The development of a performance auditing manual (currently in final draft).
- iii) The completion of various non-financial audits, described as either special audits or special reviews.

The review has been structured accordingly, and comprises:

- i) An evaluation of the current structure and skills of the Special Branch, and proposals for future development.
- ii) A review of the draft performance audit manual to determine whether it is consistent with Australian and international developments and "best practice", and whether it forms an appropriate basis for the future conduct of performance audits.
- iii) A review of the working papers and reports for all completed "special audits", together with some selected "special reviews" and some special audits currently in process.

In addition we attended the public hearing held by the PAC on 24 May 1993, at which representatives of the auditees involved in the four completed special audits were invited to give their views. We have followed up with discussions with certain of the auditees.

We also attended the public hearing held on 3 June 1993 at which the Auditor-General and three of his representatives were examined by the PAC.

In addition, we have reviewed the Office's analysis of expenditure on non-financial audit activity over the period of receipt of special funding.

The results of this review form the basis of the observations and recommendations contained in this report.

### **3.4 Advisory Committee**

The PAC established an Advisory Committee to assist in the review. The Committee comprised representatives of the Australian National Audit Office and the Victorian Auditor-General's Office, and a leading academic from the University of Technology. The insights and collective experience of the Advisory Committee were of considerable assistance in gaining additional confidence that the approach which we proposed to take to our review was addressing the correct issues, and that the tentative conclusions which were emerging were valid.

## **4. EVALUATION OF AUDIT OFFICE ACHIEVEMENTS 1991-1993**

### **4.1 Development of Performance Auditing Capability**

#### *Establishment of the Special Branch*

In anticipation of the proclamation of the amendments to the Audit Act, the Office established a "Special Branch" in February 1991. The Special Branch was established as a group dedicated to the development of the Office's performance audit capability. The Branch was given responsibility for the preparation of the performance audit manual and for overseeing and/or undertaking special audits and special reviews.

In our experience this is the appropriate approach to take when establishing a performance auditing capability, and is the approach which has been taken generally elsewhere.

In the longer term we would expect that a significant proportion of the Office's audit staff will develop the skills necessary to undertake (or, at least, identify prospective issues for) performance audits. This is the practice adopted by most audit offices, with the regular field audit teams responsible for some performance audit work (or, more accurately, with comprehensive audit responsibility for their auditees) and specialist performance audit groups undertaking the more complex engagements (particularly where the subject matter crosses multiple administrative units).

The Special Branch currently comprises eight full time staff, and is headed by an Assistant Auditor-General. Of the remaining personnel, two are new graduate recruits, four are former members of the Office's financial audit staff and one is a transferee from the Office of Public Management within the Premier's Department.

There is, of course, no necessary correlation of skills between the financial auditor and the performance auditor. There are some clear areas of overlap, particularly in the process of forensic research and evaluation. Further, a financial auditor operating with a risk-based audit methodology (as is, we understand, applied by the Office) is likely to have a range of skills which are compatible with performance auditing.

Nevertheless, it cannot be assumed that competent financial auditors will necessarily prove to be capable performance auditors. Further, those who do not come from an auditing or accounting background may well prove, with appropriate training, to be eminently suited to performance auditing.

We would therefore hope that, to the extent that the Office needs to recruit from outside to expand its performance audit function, it will look beyond the traditional qualifications of the financial auditor. The main traits of a good performance auditor - an understanding of business processes, an enquiring and analytical mind, creativity and adaptability, strong inter-personal skills and excellent written and verbal communication skills - are shared by good financial auditors, but are also found in many other disciplines.

On the basis of our review of audit work performed and considerable direct discussions with Special Branch staff, we are of the view that the individuals seconded to the Special Branch have been chosen well, and demonstrate the required mix of attributes, skills and experience.

The current composition of the Special Branch shows some breadth of background and experience. The auditor transferred from the Office of Public Management has a background in operational management consultancy. An exchange of personnel with the Audit Commission for Local Authorities and the National Health Service in England and Wales will provide the Office with another auditor from a non-financial auditing background.

*Performance Auditing Manual*

The Special Branch has expended considerable effort over the past two years in researching performance audit methodologies applied in other jurisdictions. This effort has culminated in the preparation of a performance auditing manual which is currently in final draft form.

Performance audits are much more variable in nature and scope than are financial audits. Further, performance auditing methodology is still in the process of development, whereas financial auditing methodology is supported by a well established body of performance standards and practices.

In Australia, Statement of Auditing Practice AUP 33 sets out the broad principles applicable to performance auditing, but gives little practical guidance on implementation.

AUP33 imposes the same quality control procedures on performance audits as are imposed on financial audits by Statement of Auditing Standards AUS1. In particular, AUP33 specifies the basic principles which are applicable to performance audits in the following areas:

- o integrity, objectivity and independence
- o confidentiality
- o skills and competence
- o work performed by assistants
- o work performed by other auditors and experts
- o documentation
- o planning
- o criteria
- o audit evidence
- o systems and controls

- o audit conclusions and reporting
- o recommendations

It is the policy of the Office to comply with Statements of Auditing Standards and Practice, and consequently any audit which the Office undertakes which conforms to the AUP33 definition of performance audit must comply with the requirements of that practice statement.

A copy of AUP33 is provided at Appendix 4.

Because of the variable nature of performance audits, a performance auditing manual of necessity concentrates more on providing a framework for the process of auditing, rather than in providing detailed guidance on execution.

The performance auditing manual which the Office has developed is of a high standard. It is comprehensive, written clearly and concisely and consistent with internationally-accepted practice. It provides a solid framework for the successful execution of quality performance audits.

Compliance with the manual would, in our view, also result in compliance with AUP33.

In our opinion, the Office has applied appropriate quality control procedures in developing the audit manual. In particular, the Office has used an external consultant, who is authorised by the Canadian Comprehensive Auditing Foundation ("CCAF") to present CCAF training courses, to review and approve the manual. The consultant has endorsed the manual as "one of, if not the best, performance audit manuals I have read".

*Training*

A high quality performance auditing manual is not, however, sufficient to ensure quality audits. An appropriate methodology will only result in a successful outcome if it is implemented by auditors who have the appropriate training and experience. It is therefore imperative that the Office establishes a programme of formal training to supplement on-the-job experience in developing and maintaining performance audit skills.

Thus far, most of the Special Branch personnel have not been through any formal training, but rather have acquired their skills through the research which the Branch has been undertaking in developing its methodology and, to a certain extent, through trial and error in the engagements which have been performed to date. Whilst this approach to skills development is not unreasonable in the context of the initial establishment of the performance audit function, there is a clear need to move now to incorporate a more formal element into skills development.

The Office has made some progress in this direction, having planned a series of introductory training courses in the basics of performance auditing to be delivered to approximately forty staff in late 1993. Currently, the training needs of auditors are assessed formally as part of the annual staff appraisal process, at which time personal development action plans are prepared or reviewed. Both formal and on-the-job training does, however, need to be an on-going process. The Office should be encouraged to develop a more comprehensive, structured training program designed to deliver the technical, managerial and inter-personal skills training needed by auditors as they progress through the Office.

## 4.2 Special Engagements Performed

### *Special Audits and Special Reviews*

The Office has undertaken a number of engagements over the past two years which are not attest audits of financial statements.

The Office describes these engagements as either "special reviews" or "special audits".

"Special reviews" have been defined by the Auditor-General (in a letter of 1 February 1993 to the PAC) as

"selective fact establishing reviews of specific activities, issues, transactions etc. of actual or potential interest. Special Reviews will, in the main, be financially based."

"Special audits" were described in the same letter in the following terms:

"As you would be aware, amendments to the Public Finance and Audit Act in 1992 formally expanded the role of the Auditor-General to undertake Special Audits (in particular Section 38B(1)). These audits examine the effectiveness, economy and efficiency of government agencies and their activities, and compliance by agencies with all relevant laws."

It is clear from the description of special reviews that they are not audits of the type contemplated by Section 38B(1).

They are much more narrow undertakings, designed to establish facts rather than to form opinions. This is not, of course, to suggest in any way that special reviews are not valuable exercises. In our view, they are. Nevertheless, they do appear to derive more from the Auditor-General's right under Section 52(3) to report on matters arising from his

regular auditing activity than to arise from his Section 38B(1) mandate.

They are also not "performance audits" as defined by AUP33. The limited nature of the evidence gathering and the focus on reporting facts rather than on evaluating and reporting on performance make these reviews (quite deliberately) significantly less in scope than the type of engagement contemplated by AUP33.

On one analysis, the question of the legislative basis of reports on special reviews may be considered to be one of little consequence. If the reviews are a proper exercise of the Auditor-General's authority under one or other provision of the Audit Act, and if they are considered to be undertakings of value to Parliament, then presumably no question arises as to the appropriateness in principle of their continuance.

Nevertheless, we do consider that this issue should be raised for the PAC's consideration, given that our understanding is that this current review flows from the recommendations of Report No. 49 and the resultant changes to the Audit Act. If special reviews are to be regarded as being outside of the "special auditing function" which resulted from the amendments to the Audit Act, and which is the subject of this review, then they are arguably outside the scope of activities for which the Office has received special funding over the last two years and for which it is requesting funding for the future.

We have reviewed the working papers for two special reviews:

"Eastern Creek Development and the Australian Motorcycle Grand Prix"  
(Auditor-General's Report for 1992, Volume Two).

"Disposition of State Assets for Construction of the Third Runway" (Auditor-General's Report for 1992, Volume Three).

Both reviews are essentially consistent with the description of special reviews provided

above. They are fact-gathering exercises and, within this restrictive brief, were undertaken satisfactorily. The reports resulting from the reviews are supported by sufficient appropriate audit evidence.

### *Scope of Special Audits*

The Office has issued four reports resulting from what are considered to be "special audits". These reports are titled:

- o Public Housing Construction - Selected Management Issues (issued 5 December 1991).
- o Training and Development for the State's Disciplined Services: Stream 1 - Training Facilities (24 September 1992).
- o Rental and Management Aspects of Public Servant Housing (28 September 1992).
- o The NSW Police Service - Air Travel Arrangements (8 December 1992).

The Office also issued an audit report on 17 May 1993 entitled "The London Office of the Agent-General Under the Tenure of the Honourable Neil Pickard". This audit was undertaken partly at the request of the Minister for State Development and is viewed by the Auditor-General as being a report under Section 35 of the Audit Act. It is not a "special audit" as defined earlier, and has therefore been excluded from this review.

The four special audits are discussed in detail at Appendix 5. The significant issues which arise from the audits are summarised in the following section of this report. However, a preliminary point which requires consideration is the question of the correlation between the four audits and the Section 38B(1) mandate.

Section 38B(1) empowers the Auditor-General to undertake audits to determine whether an authority is undertaking an activity "effectively and doing so economically and efficiently and in compliance with all relevant laws" (emphasis added). A literal reading of Section 38B(1) may lead to the conclusion that where the Auditor-General undertakes an audit under this Section, that audit must encompass a determination as to economy, efficiency and effectiveness. An audit which examines some, but not all, of these issues, and which does not evaluate compliance with legislation, may well not be an audit conducted under Section 38B(1).

Further, the way in which Section 38B(1) has been drafted appears to give primacy to the effectiveness element of performance auditing. This contrasts with the relevant recommendation of Report No. 49 (Recommendation 10), which proposed allowing the Auditor-General to "examine, amongst other matters, economy, efficiency and effectiveness" of a body in the acquisition or use of resources in discharging its functions. Recommendation 10 also differs from Section 38B(1) in that it did not incorporate compliance auditing.

The nature of performance auditing is such that it is inevitable that there will be considerably greater diversity of scope, approach and methodology than is the case with financial audits. If the restrictive interpretation of Section 38B(1) contemplated above is correct, the Section contemplates only audits that evaluate economy, efficiency and effectiveness, and compliance with legislation. Any examination which is narrower in scope (for example, one looking only at the potential for economising through cost savings), whilst quite possibly being a worthwhile exercise which produces significant benefit, would not, therefore, be a special audit as defined by Section 38B(1).

By way of contrast, AUP33 describes a performance audit as:

"an independent systematic examination of all or a part of an entity's programmes, operations or

activities to assess economy and/or efficiency and/or effectiveness".

AUP33 does therefore - in contrast to Section 38B(1) - envisage the selective reporting on some or all of the elements of a full-scope performance audit. Compliance auditing is not addressed by AUP33.

The Office's draft performance auditing manual defines a performance audit as:

"a constructive assessment of the extent to which financial, human, physical, information and natural resources are managed with due regard for economy, efficiency and effectiveness".

Whilst this definition embraces all three elements of economy, efficiency and effectiveness, the manual later notes that:

"in practice, the performance audit objective will focus on one or more of these interrelated elements".

It also observes that:

"Effectiveness is arguably the most important element of performance auditing. Goods or services may be provided economically and efficiently, but if they do not achieve their intended outcomes the resources used will be largely wasted".

At the same time, the Auditor-General noted in the Disciplined Services Stream 1 report that there can be inefficiency or a lack of economy even where programmes are effective, and that these aspects are thus important matters for Audit to address.

It will be evident from the detailed reviews of the four special audits undertaken to date that they are not "special audits" in the terms identified above. They clearly incorporate significant elements of a performance audit, but they do not encompass all elements. In particular, they have not focused on effectiveness as a primary audit objective. They have also generally not dealt with legislative compliance.

This is not necessarily a significant issue in terms of evaluating the appropriateness of what has occurred to date within the Office. The objective of the last two years has been to develop the Office's performance auditing capabilities. The special audits which have been performed clearly have contributed to this development, as they have all involved major aspects of performance auditing. Significant positive outcomes have resulted from the audits. Further, there is in our view considerable merit in taking a progressive approach to the development of a full performance audit capability. Nevertheless, it remains the case that the Office has yet to undertake a special audit embracing all of the elements of the Section 38B(1) mandate.

It is, however, a significant issue to consider for the future. If the Section 38B(1) mandate does contemplate full performance/compliance audits only, any future funding of Section 38B(1) audits will need to be made on a clear understanding of the scope of those audits.

The preceding paragraphs should not be taken as an endorsement by ourselves either of applying a restrictive interpretation to Section 38B(1) or of the desirability of requiring only audits that encompass all of the elements of economy, efficiency and effectiveness, as well as compliance. Rather, our inclination is towards giving the Auditor-General the ability to determine the appropriate scope for a particular engagement.

It is also not apparent to us whether this restrictive interpretation reflects the intentions or expectations of either Parliament or the PAC. We note that para 7.81 of Report No. 49 refers to the then -PAC's view that:

"various types of audit should not be defined in legislation, and that the Auditor-General should not be locked into having to conduct audits of a certain length or nature".

Further, at para 6.108 of Report No. 49 a "results-oriented" audit of performance is described as one which seeks to:

"directly judge programs or activity in terms of all or some of the three criteria of economy, efficiency and effectiveness". (emphasis added)

As noted earlier, the PAC recommendation did not incorporate a compliance audit element. A comprehensive review of compliance is not a necessary adjunct to an evaluation of economy, efficiency and effectiveness, and could readily be uncoupled from the latter three elements. The current Section 38B(1) reference to "compliance with all relevant laws" is so broad as to be potentially incapable of practical application, given the vast range of legislative provisions which can in some way be said to impact upon the operations of an audit entity. An evaluation of effectiveness would, on the other hand, seem necessarily to require a consideration of compliance with that legislation which is critical to determining the objectives of the auditee.

The issue of the scope of the special audit mandate is clearly one which needs to be addressed. If it is not intended that the only special audits which the Auditor-General can perform are those which encompass all elements of performance auditing and compliance auditing, then it may well be necessary to amend Section 38B(1) of the Audit Act.

*Observations Arising from Review of Special Audits*

1. Quality of Work

Our review of the working papers for the special audits showed a very thorough and disciplined approach to accumulating the evidence needed to support the findings of fact contained in the reports. If anything, more documentation is retained on file than is necessary, but in our experience this is common when commencing a performance auditing program. We would expect that the volume of documentation retained will decrease as the Office gains experience and confidence.

The working papers indicated an appropriate level of consultation within the Office on significant judgemental issues.

Clearly the special audits reviewed do not conform entirely to the methodology or standards established in the Office's performance auditing manual. This reflects, in large part, the fact that the development of the manual has taken place over the same period of time that the special audits have been performed.

The PAC may consider it to be beneficial to undertake a further review of the Section 38B mandate after some special audits have been completed which encompass all the elements contemplated by that section of the Audit Act (except, perhaps, compliance with all relevant laws). This review could take place under the provision of Section 48A of the Audit Act, or as a separate exercise.

## 2. Selection of Audits

There are a large range of sources from which the Auditor-General could identify suitable topics for special audits.

His financial audit staff clearly should have a good understanding of the issues which are important to their clients. They are therefore a prime source of identification of potential subjects.

The auditees themselves may well also have issues which they believe could be looked at beneficially. The Office should be encouraged to seek out the views of auditees, either at the annual audit planning meeting or through some other mechanism. As noted at page 17 of Appendix 5, the Office proposes to seek the views of agencies on suggested audit topics in 1994.

The views of Parliament are of course also important, either individually or through a forum such as the PAC. The Auditor-General advised the PAC in writing of his planned audit and review schedule for 1993, and requested any comments.

The Office should seek to draw on all available sources in identifying the special audit subjects which are most likely to result in benefit to the State. Selection of appropriate audits is of course critical. Given the very limited resources available to the Office and the almost limitless range of topics, anything which assists the Auditor-General to target his work more effectively is to be encouraged. None of this in any way detracts from the Auditor-General's sole prerogative in deciding which audits will be undertaken.

The Office have advised us that they seek input from a wide range of sources in identifying potential audit topics. These sources include the Treasury and the Office of Public Management, the media, relevant interest groups and other agencies and

Auditors-General.

There is no formal 'ranking' system by which the Auditor-General selects audit topics. Rather, it is done by judgement. We do not believe that there is any more formal or structured approach to subject selection which will produce better outcomes.

### 3. Communication with Auditees

There was a broad consensus expressed by auditees that the nature, scope and objectives of the special audits had not been articulated clearly to them. The resultant lack of understanding of the audits by auditees inhibited their ability to work with the auditors to achieve an efficient and effective audit.

It is clearly to the benefit of both auditor and auditee that the audit is undertaken in as co-operative and consultative a manner as is consistent with the independence of the audit function.

As noted in Appendix 5, the Office has taken a different and very successful approach to the auditee relationship in planning and executing Stream 2 of the Disciplined Services audit. The Office is to be commended for identifying this issue and developing an effective and innovative approach to dealing with it.

### 4. Decisions to Proceed with Audits

Performance audits generally involve considerable time being spent in the initial planning/research/survey process. It is therefore necessary periodically to re-evaluate whether the evidence which is emerging from this process justifies the continuance of the audit.

In the special audits reviewed, appropriate checkpoints had been established to give

consideration to whether significant enough issues were emerging that continuation of the audit was worthwhile.

The methodology prescribed by the draft performance auditing manual also provides for periodic reappraisal of an audit.

As discussed in some detail in Appendix 5, the Disciplined Services Stream 1 audit raised this issue from a somewhat different perspective. Briefly, whilst it was evident that significant issues were emerging from the audit, it also became evident that the affected Services were highly resistant to the basic concept of the types of collocation solutions being examined by audit.

Despite having obtained the in-principle support of one of the relevant Ministers, the effect of this resistance was to make it highly unlikely that any of the Office's proposed collocation options would be implemented. Auditee resistance is not a valid reason for deciding not to undertake a particular audit or pursue a particular line of enquiry. It may, however, indicate that, having discharged its accountability responsibilities by identifying and reporting a problem and outlining some potential solutions, the Office may produce little additional benefit by undertaking a detailed examination of potential remedies which are very unlikely to eventuate.

#### 5. Auditing Processes or Participating in Them

The function of the Auditor-General is to provide an objective, independent review of the processes of administration in the public sector, and of the outcomes of those processes. It therefore follows that the Auditor-General must remain outside of these processes. To participate in them results in a loss of independence and therefore compromises the very nature of the audit function.

In our review of the Disciplined Services Stream 1 audit, we express concern that the

Auditor-General may, for well-intentioned reasons, have gone somewhat beyond the appropriate boundaries of the audit function on this occasion.

Briefly, the Stream 1 audit identified significant under-utilisation of the training facilities of various of the Disciplined Services. The Office formed the view that various combinations of collocation of training at consolidated sites represented a practical and economic way of remedying this situation, and therefore should receive proper consideration by the Executive.

However, because the various Disciplined Services were in different administrative units, the Office had a concern that no-one was in a position to evaluate which remedy would produce the best benefit to the State as a whole or to analyse arguments against change being mounted by some of the Services.

The Office therefore took on the responsibility of performing detailed analysis of the economics of the various options which it had identified, and made a very clear identification of the option which, in its view, produced the greatest economic benefit.

Because this analysis is a critical part of the process which would have led to a decision on how to remedy the under-utilisation of facilities (had Government decided to pursue any of the report's collocation options), it would more appropriately have been performed by the decision makers than by the Office. The Office certainly needs to undertake sufficient analysis to satisfy itself that actions which it is proposing are feasible, but in going beyond that it risks becoming a part of the decision-making processes of administration of the public sector.

The draft performance auditing manual acknowledges (in our view, correctly) that "the focus of recommendations is to indicate what improvements are necessary rather than to indicate specifically how to achieve them", and that "recommendations should therefore be kept at a high level and not get too specific".

The Office remains of the view that in the particular circumstances of this audit the level of detailed work actually performed was necessary to support the feasibility of the possibilities it had identified and hence to ensure that this issue received due consideration, as it did, by the Executive.

#### **4.3 Financial Analysis**

The Office has provided an analysis of the expenditure on special audits and special reviews in the Office's 1990/91, 1991/92 and 1992/93 (to 5 May 1993) years. The Office has a 30 November balance date. That analysis is provided at Appendix 3.

The Office has been able to keep track of expenditure on special audits and reviews by means of the Office's job costing system, which accumulates audit time by project.

The following points are noted from a review of Appendix 3:

1. A total of \$2,590,000 has been spent by the Office on special audits and reviews in the period. This total comprises:

	\$' 000
Administration of the special audit function	709
Performance of special audits	1,145
Performance of special reviews	706
Other costs	<u>30</u>
	<u>2,590</u>

2. None of the above work was billable to auditees. As discussed earlier, \$1,000,000 of special funding has been provided over the period. Consequently the remaining \$1,590,000 of costs identified in Appendix 3 but not billed directly to auditees has in effect been funded by fees received for financial audits.

### *Special Audits Review*

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It was noted previously that the Office has for some time undertaken special reviews of various types (some of which were previously called "type D" work), which have in effect been funded by financial audit revenue.

It may, therefore, be more appropriate to view the costs as summarised above, net of special review costs, as representing the costs incurred in meeting the expanded audit mandate. These costs total \$1,884,000, and therefore still exceed the special funding by \$884,000.

3. The time and cost of the four special audits reported on to date are:

<u>Audit</u>	<u>Hours</u>	<u>Fees (\$'000s)</u>
Public Housing Construction	3,576	365
Disciplined Services Training - Stream 1	3,051	376
Public Servant Rental Housing	1,111	119
Police Air Travel	436	72
Roads and Traffic Authority of NSW		
	<u>8,174</u>	<u>932</u>

4. The Office incurred 975 hours and costs of \$147,000 in developing the performance auditing manual.
5. \$13,700 has been spent on additional equipment, mainly on computer equipment and office furniture. The Special Branch occupies a modest amount of space within the Office's Kent Street and Sussex Street premises.
6. Expenditure on outside consultants has been very low at \$9,000 (representing

primarily costs of the Valuer-General). The low level of use of external expertise in large part reflects the primarily financial nature of special audits performed to date. As the Office starts to undertake audits which have a primary focus on effectiveness it will need to make more use of experts, particularly in areas not susceptible to financially-based analysis of outcomes.

The analysis of expenditure provided at Appendix 3 captures all time spent on special audit or review-related activity by all Office staff, be they Special Branch or field audit personnel. The Office has estimated the annual cost of maintaining the Special Branch at its current staffing level of eight to be approximately \$1,000,000.

The effect of the special funding has been to enable the Office to increase the proportion of total Office expenditure dedicated to special audits and reviews from 3.5% in 1989/90 to an average of 7% in 1990/91 and 1991/92.

## 5. FORWARD FUNDING REQUEST

In its submission at Appendix 5, the Office has requested that future funding for special audits and special reviews be provided at the following levels:

<u>Year (30 June)</u>	<u>\$ Million (1993 Values)</u>
1994	1.60 *
1995	2.36
1996	2.90
1997	3.06

\* The Office advises that this figure has subsequently been revised to \$1.68 million.

In a later letter to the Treasury, the Auditor-General indicated that he would be able to resource up to \$1 million of the annual funding requirement internally. With planned expenditure of \$1.68 million in the year ended 30 June 1994, the Auditor-General indicated to the Treasury that this suggests a Treasury provision of \$0.75 million for the 1993/94 fiscal year. Based on subsequent internal funding of \$1 million per annum, there would be a need for Treasury appropriations to rise progressively to approximately \$2 million by the 1996/97 fiscal year to meet planned expenditure of \$3.06 million in that year.

Appendix 5 shows that the Office provided a total of \$1.6 million of internal funding over the last two years.

The funding requests have been calculated based on total budgetted Office expenditure for 1992/3 of \$15.31 million and a gradual increase in the proportion of total Office effort

applied to special audits, as follows:

<u>Year (30 November)</u>	<u>%</u>
1993	7.5
1994	12.5
1995	17.5
1996	20.0

Issues to be considered in respect of the above estimates are:

1. The estimates assume full recovery of the costs of special reviews, as well as special audits, from special funding. As explained earlier, the Office has for some time funded the special review activity out of financial audit fees. Is the special funding intended to fund the expanded audit mandate provided by Section 38B, or is it to fund all activities which cannot be billed directly to auditees?
2. The method by which funding is approved needs to be considered. Significant considerations include:
  - i) Should authority for approving budgets lie with the Executive or with Parliament? Given that the role of the Auditor-General is to report to Parliament on the activities of the Executive, logic would seem to suggest that the Office's budget should be submitted to Parliament for review and approval;
  - ii) Should a mechanism for determining funding be put in place (such as that proposed by the Auditor-General) to enable the Office to plan its resource needs with some confidence, or should funding be revisited annually (thereby giving Parliament and/or the PAC an opportunity each year to consider and attribute a value to the work of the Office)?

Even if a longer-term funding mechanism is considered to be the preferred approach in future years, the PAC may nevertheless well decide that its current funding recommendation will only be for a year or two. This will enable the PAC to re-evaluate the Office's continued progress towards meeting its Section 38B(1) mandate.

3. Clearly, the pattern of expenditure in future years will be different to that incurred to date. Much of the effort devoted to research into methodologies and development of the manual will in future be available for the conduct of audits. The costs of formal training and staff development will, on the other hand, become significant.
4. The proposal to reach a level of 20% performance auditing by 1996 is reasonable in comparison to levels maintained in other jurisdictions. There is no objective 'right' level of performance auditing; it will be up to Parliament to continue to monitor the level of output from the Auditor-General and form a view as to whether it is meeting their needs and expectations.

## 6. OTHER MATTERS

In conducting this review, certain matters have arisen which, whilst not directly relevant to the terms of the engagement, are nevertheless significant to the effective performance of the Auditor-General. These matters are therefore raised for consideration.

### *Audit v. Management Consultancy*

A number of comments made by auditees at the 24 May 1993 public hearing showed a lack of understanding of the critical way in which the accountability responsibilities of the Auditor-General constrain the scope of the Office's work. This confusion is by no means unique to New South Wales. We have experienced it in other jurisdictions.

It is not the function of the Auditor-General to provide management consultancy services. The function of the Auditor-General, as defined by the Audit Act, is to facilitate the accountability of the Executive to Parliament. The Auditor-General must, therefore, stay outside of the management processes of government.

A number of auditees made suggestions such as performance audit subjects being agreed between themselves and the Office, or that the Office should consider itself as a tool to help management manage better. There may well be a role for such consultancy functions, either within individual agencies or as a service of the Central Agencies. It is quite clearly not the role of the Auditor-General (although this does not preclude the audit function being approached in a pro-active, business-like manner).

It may be helpful for auditees to be provided with a statement explaining the purpose of the Section 38B mandate, and its implications for the role and responsibilities of the Auditor-General.

*Follow-up of Audit Reports*

The observation was made more than once at the 24 May 1993 public hearing that there seems to be no process in place whereby someone takes ownership of the Auditor-General's reports and recommendations and follows up on their implementation. The Auditor-General has no mandate to implement change. There is a consequent risk that the benefits that should be obtained from performance audits (and also financial audits) are not realised due to lack of follow up.

The need for someone to take this role is particularly important where an audit deals with issues that cross the responsibilities of multiple administrative units.

*Performance Reporting in the Public Sector*

Current performance auditing mandates in most parts of the world require the auditor to report directly on performance.

This contrasts with the financial audit process, where management makes representations (in the form of financial statements) and the auditor reports on management's representations.

Performance audits which require direct reporting by the auditor are usually time-consuming and costly undertakings. One reason for this is that the auditor generally spends a significant amount of time trying to determine the auditee's objectives, the appropriate means of measuring performance against those objectives and the relevant benchmarks against which to evaluate performance.

Clearly, the establishment and reporting of performance measures should form an integral part of the auditee's own internal management processes. In practice, it rarely does so.

Therefore there is an emerging trend overseas to move away from performance audits in which the auditor reports directly on performance, to audits in which management makes written representations on performance and the auditor reports on (that is, attests to) those representations.

There are at least two clear benefits to this approach. Firstly, auditee management is forced to focus on performance measurement and evaluation. This produces benefits in the form of improved management accountability. Secondly, audits can be completed in less time and for less cost, enabling greater coverage to be obtained from scarce resources.

This issue is, of course, beyond the scope of the current review. It is, however, worthy of further consideration in the broader context of improving the performance both of public sector entities and of the Auditor-General.