



LEGISLATIVE ASSEMBLY

Public Accounts Committee
REPORTING AND AUDITING REQUIREMENTS FOR SMALL
AGENCIES

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CHARTER OF THE COMMITTEE

The Public Accounts Committee has responsibilities under Part 4 of the *Public Finance and Audit Act 1983* to inquire into and report on activities of Government that are reported in the Total State Sector Accounts and the accounts of the State's authorities.

The Committee, which was first established in 1902, scrutinises the actions of the Executive Branch of Government on behalf of the Legislative Assembly.

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

CHAIRMAN'S FOREWORD

I am pleased to present this report on the reporting and auditing requirements for small agencies.

This inquiry was prompted by a comment in an independent review of the Audit Office regarding the potential inefficiency of auditing small agencies.

In 2002, the Committee of the previous Parliament decided to investigate whether there was in fact any inefficiencies in auditing of very small agencies in New South Wales. The Committee also chose to examine whether the costs of complying with the requirements of reporting to Parliament were too high for some agencies in relation to their level of assets or the operational risks they faced.

In an effort to establish the extent of the problem, this Committee and the Committee of the previous Parliament consulted widely with the state public sector, and academic and professional accounting bodies. All State Ministers were contacted directly. The inquiry was advertised in the metropolitan and national press.

The Committee did not receive a large number of submissions. The Committee was not presented with a large amount of evidence to suggest that the current arrangements cause much inconvenience for the majority of public sector entities.

The Committee heard, particularly from central agencies and accounting bodies, that the principle of accountability for public funds should be upheld despite the expense. It essentially agrees with this view.

For these reasons, the report does not recommend that there be widespread changes to current accountability arrangements. Rather, the report recommends that Ministers and agencies have regard to the cost of meeting accountability requirements when establishing a reporting entity with proper controls. It also recommends that the continued appropriateness of these reporting arrangements be examined annually.

The report makes a small number of recommendations about improving the efficiency of reporting and auditing requirements. In particular, the Committee was concerned with the high cost of the administrative burdens reported by the Rural Lands Protection Boards. The Committee recommends that the Minister consider moving their reporting date as a way of addressing these costs caused by seeking access to high quality accounting services during the summer holiday period.

I would like to thank all the individuals and organisations who contributed to the inquiry and the staff of the secretariat for preparing this report, particularly Vicki Buchbach. I would also like to thank David Daniels who, while on secondment from the Audit Office, provided technical assistance which greatly assisted in drafting this report.



Matt Brown MP
Chairman

LIST OF RECOMMENDATIONS

Recommendation 1: The Treasurer or responsible Minister should periodically review the continued need for the Auditor-General to audit each entity not administering public funds on the “invited audit” list (those prescribed in the regulation for the purposes of section 45 of the *Public Finance and Audit Act 1983*). If the audit is no longer deemed necessary, then the entity should be removed from the list.

Recommendation 2: The Treasurer should review the continued appropriateness of reporting arrangements in light of advice issued by the Australian and International standard setting bodies about the treatment of small and medium enterprises if this advice applies to public sector agencies and recommend appropriate changes to Parliament.

Recommendation 3: In exceptional cases where a financial reporting requirement is imposing an “unreasonable burden” on agencies, agencies should approach the Treasurer for an exemption from that requirement. Guidelines should be developed to determine what constitutes an “unreasonable burden”.

Recommendation 4: In discussing planned audits, the Audit Office should provide information to agencies so that cost-effective auditing practices are used and the appropriate level of audit effort is applied where agencies are small and low risk.

Recommendation 5: Senior managers of agencies should monitor auditing costs for small agencies under their control. Where there is a greater than 25% change between years, a review of the reasons for this change should occur and be discussed with Treasury and the Audit Office.

Recommendation 6: Ministers should review the suitability of the structure of the organisations that they control taking into consideration accountability, as well as legislative and service delivery constraints, on a regular (ideally annual) basis. At a minimum, the structure of an agency should be reviewed when the auditing costs become more than 5% of whichever is the smallest of an its income or its expenses or its assets.

Recommendation 7: Guidelines should be developed by the Premier’s Department to assist Ministers and agencies to consider the full costs of complying with financial and annual reporting requirements prior to establishing an agency. In particular, consideration of reasons for establishing as a separate entity should be balanced against the marginal cost of auditing decreasing with the increasing size of the agency.

Recommendation 8: The Minister for Primary Industries should propose amendments to the *Rural Lands Protection Act 1998* in order to change the date for the financial and annual reporting for the Rural Lands Protection Boards to a more administratively convenient date. In the short term, the Minister should request the Treasurer to determine a more convenient reporting date.

Recommendation 9: Engagement letters for audits undertaken under section 45 of the *Public Finance and Audit Act 1983* should be revised to include a consideration of whether the audit continues to be required.

Recommendation 10: The Treasurer should write to responsible Minister concerning the continued need for agencies to be included in the “invited audit” list at five yearly intervals prior to the statutory review of the regulation.

Chapter One - Conduct of the Inquiry

- 1.1 The Public Accounts Committee has the power to make recommendations in relation to the form of accounts and to comment on any report of the Auditor-General. Part of its role is oversight of the reviews of the NSW Audit Office which are performed by independent reviewers every three years.
- 1.2 In his Review of the Audit Office undertaken in 2000, Professor Craswell, then of the University of Sydney, commented that the mandatory auditing of very small agencies could be a source of inefficiency and the costs of the audit could be a financial burden. Recommendation 13 of the Review stated:

The Auditor-General should discuss with Treasury alternative proposals for auditing small clients.¹
- 1.3 The Committee of the 52nd Parliament was advised that the Audit Office and Treasury have discussed this issue but considered reporting requirements were more appropriately determined by Parliament, which represented the interests of the public users of this information.²
- 1.4 As this subject was within the area of operations of the Public Accounts Committee, in 2002, the Committee resolved to investigate the matter of auditing and reporting requirements with a view to bringing any feasible improvements to the attention of Parliament.³

DISCUSSION PAPER

- 1.5 As a first step, the Committee developed and released a discussion paper in order to open debate on these issues. The discussion paper canvassed issues relating to the efficiency and effectiveness of reporting and auditing arrangements. It asked a number of questions in which are listed in Appendix 1. The full discussion paper is available from the Committee website.
- 1.6 The Committee consulted widely by calling for public submissions by advertising the inquiry in the *Sydney Morning Herald* and the *Australian Financial Review* in November 2002. It also directly sought submissions from all State Ministers, the Auditor-General and a range of academic and accounting professional bodies.
- 1.7 In response to the paper, the Committee has received 13 submissions from individuals and organisations. A list of submissions and other correspondence received by the Committee is at Appendix 2. These submissions are available on the Committee's website.
- 1.8 The Committee ceased to exist when the term of the Legislative Assembly expired on 28 February 2003. An election was held on 22 March 2003 and a new Public Accounts Committee was appointed on 8 May 2003 for the duration of the 53rd Parliament. All the papers of the previous Parliament were referred to the new Parliament.

¹ Public Accounts Committee *Review of the Audit Office of New South Wales under section 48A of the Public Finance and Audit Act 1983*, Report No 2/52, 120, NSW Parliament, Sydney, 2000, p 22

² Discussion between Secretariat and Deputy Auditor-General, 28 August 2002

³ Minutes of the Public Accounts Committee 15/2002, 8 October 2002, Item 4

- 1.9 The new Committee is empowered to consider evidence taken by a prior Committee as if it had taken it itself under section 58(10) of the *Public Finance and Audit Act 1983*. Further, on 28 May 2003, the Legislative Assembly resolved to refer to a number of statutory standing committees all documents and proceedings of any committee appointed during the 52nd Parliament for similar purposes.⁴

TERMS OF REFERENCE

- 1.10 On 18 June 2003, the new Committee agreed to continue this inquiry. The Committee also adopted the following terms of reference for the inquiry:

The Public Accounts Committee of the New South Wales Parliament has determined that it will review the effectiveness and efficiency of the requirements for financial reporting and auditing for small agencies under the *Public Finance and Audit Act 1983*.

The 2000 review of the Audit Office identified the requirement to audit small agencies as a potential source of inefficiency.

The Committee will examine the requirements for reporting and auditing in the relevant legislation and accounting standards and report on:

- a) The appropriate balance for small agencies between the costs of reporting and auditing and accountability for public money and assets;
- b) Relevant issues, such as size, mission and risk profile, for establishing whether agencies should be separate entities required to prepare reports and be audited;
- c) Alternative arrangements for agencies where the cost of reporting is disproportionate to their size, including differential reporting requirements or concise financial reports;
- d) Appropriate criteria for reviewing whether organisations not otherwise covered by the requirements for auditing should be continue to be on the “invited audit” list; and
- e) Any other relevant issue.

HEARING

- 1.11 On 15 July 2003, the Committee held a public hearing at Parliament House where 14 witnesses gave evidence as part of the inquiry. A list of these witnesses is at Appendix 3. The transcript of this hearing can be found on the Committee’s website. The Committee received a number of supplementary submissions and responses to questions raised in the hearing. A list of these is also included in Appendix 2. The Committee would like to thank all the individuals and organisations who contributed to the inquiry.

STRUCTURE OF REPORT

- 1.12 Chapter Two briefly describes the requirements for reporting and auditing for public sector entities in New South Wales. Chapter Three assesses the level of problems with the current arrangements for smaller agencies which were reported to the Committee. Chapter Four canvasses and evaluates various options for addressing problems. It also includes the Committee’s conclusions and recommendations.

⁴ Legislative Assembly Parliamentary Debate, 28/5/03, p 1349

Chapter Two - Reporting and Auditing Arrangements

2.1 This Chapter describes the current requirements for reporting to Parliament by public sector agencies and provides a brief discussion of the reasons for establishing these arrangements.¹

ACCOUNTABILITY TO PARLIAMENT

2.2 At the heart of the Westminster system of democracy is the concept that Parliament should supervise spending by the Executive Government. Parliament does this on behalf of the people it has been elected to represent.

2.3 In New South Wales, this concept is manifested in the *Constitution Act 1902* which includes a requirement that Parliament pass legislation in order for appropriations to be made from the Consolidated Fund.² In practice, this means that the Executive is accountable to the public through the Parliament by using the Budget to describe the purposes it wishes to spend money from that fund. This money can only be spent once Parliament has passed the Appropriation Bills.

2.4 The Executive is also accountable through legislative requirements to report to Parliament on the results of expenditure by agencies in annual reports. The Auditor-General reports to Parliament about the accuracy of financial accounts provided to Parliament and each agency's report requires an auditor's certification.

2.5 Since the late 1970s, the importance of broader accountability to Parliament and the public has been increasingly recognised. Reforms to reporting requirements in New South Wales were made with the aim of producing directly comparable financial accounts for agencies across the public sector. This included those agencies receiving funds from the Budget process and those raising funds from other sources such as through levies or business activities. A key reform was the introduction of accrual accounting for all agencies. Other enhancements to reporting requirements were introduced as a way of improving the level of information available to the public about the operations of agencies.³

LEGISLATION

2.6 The requirements for reporting and auditing are contained in legislation, standards and mandatory directions from the Treasurer made in accordance with the legislation.

2.7 The key pieces of legislation are:

- *Annual Reports (Departments) Act 1985*,
- *Annual Reports (Statutory Bodies) Act 1984* (together these are called the Annual Reporting Acts), and
- *Public Finance and Audit Act 1983* (the PFAA).

2.8 Agencies are also required to comply with relevant subordinate legislation such as the *Public Finance and Audit Act Regulation 2000*.

2.9 The annual reporting legislation requires an annual report to include:

¹ For the sake of simplicity, unless otherwise stated, this report uses the term "agency" to mean both statutory bodies and departments.

² sections 39 and 45

³ D Nicholls, *Managing State Finance*, Sydney 1991, p 239, pp 242-243

- audited financial statements,
 - the opinion of the auditor,
 - response of the department head or statutory body to the auditor's opinion, and
 - a report of operations.⁴
- 2.10 The regulations to the Annual Reporting Acts contain detailed requirements for the content of reports of operations by departments and statutory bodies.⁵ Although the requirements for departments and statutory bodies are similar, there are some variations to reflect their different circumstances. For instance, statutory bodies are required to include statements of their investment strategies and their budgets but departments are not. Other requirements are included in memoranda from the Premier or the Treasurer.
- 2.11 Agencies are also required to report on their aims and objectives, management structure, staffing, use of consultants, grants to other bodies and any legislative changes during the reporting period. Reports must disclose information about controlled entities. Agencies should describe their major activities throughout the year, including using qualitative and quantitative performance measures where appropriate. Reports include information on agencies' performance against such public sector wide policies as:
- Timeliness of paying accounts;
 - Disposal of property;
 - Equal Employment Opportunity outcomes, plans and trends;
 - Disability plans;
 - Risk management and insurance activities;
 - Ethnic Affairs Priorities Statements;
 - NSW Government Action Plan for Women;
 - Occupational Health and Safety;
 - Implementation of the Government's Waste Reduction and Purchasing Policy;
 - Outcomes of goals under the Government's Energy Management Policy;
 - Use of credit cards; and
 - Statistics relating to Freedom of Information requests.⁶
- 2.12 A Premier's Memorandum requires agencies to minimise the production costs of annual reports. However, it is likely that gathering the information to meet these comprehensive reporting requirements could impose significant compliance costs on agencies.

Types of agencies required to report

- 2.13 All agencies listed in Schedules 2 and 3 to the PFAA are required to prepare annual financial statements for audit by the Auditor-General. Schedule 2 consists of a list of statutory bodies and Schedule 3 is a list of departments. These lists are regularly updated due to machinery of government changes. As of August 2004, there are 127 separate statutory bodies listed in Schedule 2. A number of these references to statutes cover many individual bodies. For example the list includes "a marketing board constituted under the *Marketing of Primary Products Act 1983*" and "a

⁴ section 7 *Annual Reports (Statutory Bodies) Act 1984*, section 9 *Annual Reports (Departments) Act 1985*

⁵ *Annual Reports (Departments) Regulation 2000*, *Annual Reports (Statutory Bodies) Regulation 2000*

⁶ NSW Treasury, *Annual Reporting Review – Compliance Checklist*, August 2003

catchment management authority under the *Catchment Management Authorities Act 2003*". There are 47 departments in Schedule 3.

- 2.14 The PFAA definition of "statutory body" and "department" extend to entities controlled by these bodies which, therefore, must meet the same financial reporting and auditing requirements.⁷
- 2.15 The Annual Reports Acts define statutory bodies and departments as those agencies listed in Schedules 2 and 3 of the PFAA.⁸ This means inclusion in these Schedules also confers a requirement on the listed agencies to prepare an annual report.
- 2.16 The entities listed in the PFAA Schedules may control entities that are not listed in the PFAA Schedules. In this situation, the controlled entities are not caught by the Annual Reports Acts and so are not required to prepare separate annual reports. As controlled entities are consolidated within the financial report of the appropriate "parent" agency, information about them is disclosed in the parent agency's annual report, although at a consolidated level.
- 2.17 Sections 44(1) and 45 of the PFAA provide for the Auditor-General to undertake "particular" audits of statutory bodies and funds at the invitation of the Treasurer or a Minister. As these entities are not listed in the PFAA Schedules or controlled by an agency listed in the PFAA Schedules, they would otherwise fall outside the ambit of the Act. As of August 2004, there were 46 agencies and 15 funds prescribed for this purpose in the regulation (the invited audit list). As they are not scheduled entities, the Annual Reports Acts do not apply to these agencies, although some may choose to prepare annual reports.

Flexibility in legislative requirements?

- 2.18 The reporting legislation provides scope for the Treasurer to vary the requirements for individual agencies. In particular, there is provision to exempt organisations from a particular requirement where it would be unreasonably burdensome.
- 2.19 Section 41BA of the PFAA states:
- If after consulting the Auditor-General, the Treasurer is satisfied that compliance with a provision of this Act or the regulations which relates to the form or content of financial statements:
- a) would render the financial statements of a statutory body misleading, or
 - b) would be inappropriate to the circumstances of a statutory body, or
 - c) would impose unreasonable burdens on a statutory body
- the Treasurer may by notice in writing exempt the statutory body from compliance with the provision or declare that the provision applies to it as if omitted or modified or varied in a specified manner.
- 2.20 The Act provides that such exemptions can be general or specific and varied at any time by the Treasurer. Similar powers in relation to departments are described in section 45EA.
- 2.21 As an alternative, there is the possibility that small agencies could be declared not to be departments or statutory bodies for the purpose of auditing and financial reporting,

⁷ Sections 39(1A), 45A(1A)

⁸ Section 3 ARDA, Section 3 ARSDA

through sections 39(1B) or 45A(1B) of the PFAA. The Committee understands that the effect of such a declaration is that the entity, while a reporting entity under the Accounting Standards, would then not be required to prepare financial statements and have them audited by the Auditor-General.

2.22 This would be the equivalent of small agencies being given a reporting and auditing exemption. While there is flexibility in the legislation for this form of declaration, the Committee sees risks in excluding entities from the PFAA. NSW Treasury have also emphasised the risks of excluding agencies from their reporting obligations.⁹

2.23 The annual reporting legislation also provides for exemptions. For instance, annual reports can include unaudited financial statements so long as this is clearly stated in the report. Agencies can seek extensions of time for the completion of reports.¹⁰ The Treasurer also has very broad powers to grant exemptions from the reporting requirements. Clause 13 of the *Annual Reports Departments Regulation 2000* provides:

(1) The Treasurer may, on application by a Department Head made at any time, grant an exemption from any or all of the provisions of this Regulation, other than subclause (4), in relation to the annual report of the Department for a particular reporting year.

(2) An exemption may be granted subject to such conditions as the Treasurer may determine.

(3) An exemption ceases to apply if the Treasurer, by notice in writing, so informs the Department Head to whom the exemption was granted.

(4) Details of an exemption, and the reasons for the exemption, must be included under a separate heading entitled "Exemptions from the Reporting Provisions" in the annual report for the reporting year in which the exemption applies.¹¹

2.24 However, there are consequences for agencies if exemptions are provided. In accordance with Australian Auditing Standards, the Audit Office details the results of each agency's annual financial audit in an "Independent Audit Report". In this report the Audit Office expresses an opinion on whether the audited agency's financial report presents in accordance with applicable Australian Accounting Standards, and complies with section 41B (for statutory bodies) or 45E (for departments) of the PFAA. The Independent Audit Report is published in agency annual reports.

2.25 If the Treasurer were to give a "material" exemption from a financial reporting requirement, the Audit Office would be compelled by Australian Auditing Standards to express a "qualified" opinion on that agency's financial report, as it would then not comply with either or both the Australian Accounting Standards or the PFAA. A "material" exemption would be one that in the Audit Office's opinion could be significant enough to adversely affect decisions made by users of the financial report.

2.26 Apart from a qualified audit opinion, the cost of the Treasurer approving such an exemption would be less financial reporting disclosure, and, therefore, arguably less accountability. Mr Martin Smith, Principal Policy Analyst within NSW Treasury, made the following comments on this issue:

Mr SMITH: If the Parliament decides it needs a separate existence there would be a strong presumption at Treasury that Parliament also wants financial information

⁹ Mr Ian Neale, Executive Director, NSW Treasury, transcript of hearing p 32

¹⁰ ARDR c6, ARSB c9; ARDA s16 (5), ARSBA s13(5)

¹¹ clause 13. Clause 19 of the ARSD Regulations provide equivalent powers in relation to statutory bodies.

separately reported. Is it possible for those funds just to be administered by a department and be reported as part of that department? Yes, that certainly is an option.¹²

- 2.27 Therefore, while the Treasurer has flexibility under current legislation to grant financial reporting relief in certain circumstances, he or she is very unlikely to do so due to the resulting loss of accountability. The Committee understands that no such exemptions have been issued since at least March 2001.
- 2.28 It is clear that the current legislative requirements contain flexibility in certain circumstances, and could be used to reduce the compliance burden for particular agencies. However it is also clear that under the current system, the Treasurer is unlikely to grant such relief in practice.

Accounting Standards

- 2.29 The NSW legislative financial reporting requirements are based on the national accounting standards.
- 2.30 Historically, some of these, such as AAS29 “Financial Reporting by Government Departments”, were developed specifically for the public sector. Since 2000, standards have been developed to apply to all types of entity.
- 2.31 The Australian Accounting Standards Board (AASB) issues Australia’s national accounting standards. For reporting periods beginning on or after 1 January 2005 the AASB is adopting the Standards of the International Accounting Standards Board (IASB). These standard are sector neutral in that they are applicable to both for-profit and not-for-profit entities, including public sector entities.
- 2.32 The use of Australian Accounting Standards is mandated in the private sector through the *Corporations Act 2001*. There is no similar single piece of legislation mandating their use in state public sectors: rather it is a matter for relevant state governments to mandate their use. The application of Australian Accounting Standards to NSW public sector agencies is mandated:
- For statutory bodies, through section 41B(1) of the PFAA, and
 - For government departments, through the Financial Reporting Code, which Treasury issues under section 45E(1)(b) and 9(2)(n) of the PFAA.
- 2.33 In 2001, Treasury issued a circular advising agencies of a withdrawal of all exemptions from reporting requirements where these would result in a conflict with the Accounting Standards.¹³ As a result, since 2001 onwards, all NSW Government agencies have been required to comply fully with Australian Accounting Standards.
- 2.34 The application of Australian Accounting Standards is also mandatory for members of the professional accounting bodies, the Institute of Chartered Accountants in Australia and CPA Australia.¹⁴

“Reporting Entity” Concept

- 2.35 Underpinning the national accounting standards is the “reporting entity” concept. The standards require an entity that is a reporting entity to prepare general purpose

¹² Mr Martin Smith, transcript of hearing p 39

¹³ NSW Treasury, Accounting Standards Update TC01/04, issued 14 March 2001

¹⁴ AASB “Standards”, www.aasb.com.au, citing Miscellaneous Professional Statement APS 1 “Conformity with Accounting Standards and UIG Consensus Views”

financial reports (GPFR). A GPFR is a financial report prepared in compliance with all of the national accounting standards and associated mandatory requirements. Under the Statement of Accounting Concepts 1 (SAC 1) “Definition of the Reporting Entity”, a GPFR is:

Intended to meet the information needs common to users who are unable to command the preparation of reports tailored so as to satisfy, specifically, all of their information needs.¹⁵

- 2.36 An entity can be a reporting entity, regardless of its legal status. SAC 1 defines a reporting entity as “an entity for which users exist who are dependent on general purpose financial reports (GPFR) for information for making and evaluating resource allocation decisions”. An entity, which does not have a separate legal status, can therefore be a reporting entity through the existence of dependent users.
- 2.37 An entity that is not a reporting entity under the standards is able to prepare special purpose financial reports (SPFR). A SPFR is a financial report prepared to meet the information needs of a particular user who possesses the authority to command the disclosure of the information required. Unlike a GPFR, a SPFR does not contain all of the information required by the national accounting standards and associated mandatory requirements. However, a SPFR is sufficient for non-reporting entities because, even if the financial reports are insufficient, the users have the authority to command additional tailored financial information.
- 2.38 The standards identify three primary factors to consider when assessing whether users exist that are dependent on an entity’s financial report for their information needs (ie whether an entity is a reporting entity):
- Separation of management from economic interest,
 - Economic or political importance, and
 - Financial characteristics such as value of assets and number of employees.¹⁶
- 2.39 The greater the extent of these factors, the more likely it is that there will exist users dependent on general purpose financial reports for making and evaluating resource allocation decisions. In the public sector, “management” refers to the government, while the “economic interest” refers to the electorate. As government agencies do not own resources in their own right, but instead are administering resources “owned” by the taxpayer, there is virtually always a separation between “management”, and the “economic interest”. As a result most, if not all, government departments and statutory authorities will be reporting entities. Reflecting this, SAC 1 states that:
- It is fundamental that those who manage resources on behalf of others should account for their performance to those who have provided the resources.¹⁷
- 2.40 Consistent with this position, Australian Accounting Standard 29 “Financial Reporting by Government Departments” states that:
- Consistent with SAC 1, this Standard adopts the view that most, if not all, government departments are reporting entities and should prepare general purpose financial reports in respect of each reporting period.¹⁸

¹⁵ Statement of Accounting Concept 1, “Definition of the Reporting Entity”, paragraph 6

¹⁶ *ibid* p 9

¹⁷ Statements of Accounting Concepts, SAC 1 *Definition of the Reporting Entity*, paragraph 24

¹⁸ AAS 29 “Financial Reporting by Government Departments”, paragraph 5.1.2

2.41 Ms Naomi Carroll, Technical Adviser from CPA Australia, gave the following evidence on whether users exist in relation to small agency financial reports:

Ms CARROLL: ...CPA Australia believes there are many and varied users of audited financial reports for public sector small agencies. Clearly parliamentarians form part of the governance structure. In addition, the general public are also considered users. Without the need for these agencies to be held accountable, financial reports may lose their relevance, reliability and comparability.¹⁹

2.42 Mr Martin Smith from NSW Treasury, also gave evidence on whether small public sector entities would be considered reporting entities under Australian Accounting Standards:

Mr SMITH: ...I must point out that there is a presumption in the accounting standards that if an entity is important enough to have a separate existence it is important enough to perform separate accounting.²⁰

2.43 This means that, even for very small agencies that administer few resources with limited risk, there is still a strong argument that they should prepare general purpose financial reports. Parliament ultimately is accountable to ensure public monies are applied efficiently and effectively, regardless of the size of the agency.

2.44 As noted above, the Australian Accounting Standards Board is adopting the Standards of the International Accounting Standards Board (IASB) for reporting periods beginning on or after 1 January 2005. The international standards have no equivalent definition of "reporting entity". However the AASB has announced that it will retain the reporting entity concept.²¹

Flexibility in the Accounting Standards?

2.45 There is an appearance of flexibility in the application of the reporting entity concept. The stated purpose of Statements of Accounting Concepts is to provide guidance to the standard development process. These concepts do not have the force of a standard and do not override or amend accounting standards. The level of authority given to such concepts depends on the legislative weight in relevant jurisdictions.²² This implies that Parliament could approve different financial reporting arrangements for some types of agency if it considered this appropriate.

2.46 However, in practice, there is no flexibility in the accounting framework. It is mandatory for all professional accountants to comply with the Accounting Standards and Auditing Standards. Members are also required to apply the "reporting entity" concept defined in SAC 1, through their professional standards as a condition of membership of the professional bodies. Virtually all key accounting staff in agencies, NSW Treasury and the Audit Office are members of one of the professional accounting bodies.

2.47 In addition, AAS29 "Financial Reporting by Government Departments" refers to the "reporting entity" concept. In effect, this gives the concept the force of a standard.

2.48 On this basis, it seems that there is no opportunity for financial reporting to deviate from the accounting standards without resulting in a qualified auditor's certification.

¹⁹ Ms Naomi Carroll, transcript of hearing p 23

²⁰ Mr Martin Smith, transcript of hearing p 35

²¹ AASB "Framework for the Preparation and Presentation of Financial Statements", paragraph 8

²² AASB Policy Statement 5, pp 5-6

ROLE OF AUDITOR-GENERAL

- 2.49 The NSW Audit Office, headed by the Auditor-General, undertakes annual financial audits of the financial statements of:
- the agencies listed in Schedules 2 and 3 of the PFAA;
 - any entities that are controlled by the agencies listed in Schedules 2 and 3 of the PFAA; and
 - the entities listed in the regulation to PFAA.
- In 2002/03, 400 financial audits were performed.²³
- 2.50 The PFAA requires agencies to forward financial statements to the Audit Office within 6 weeks of the end of the financial year. The Auditor-General is to audit the financial statements within 10 weeks of receiving them. Parliament is informed in reports by the Auditor-General if agencies do not meet this deadline.
- 2.51 Under the PFAA, the Auditor-General is required “to have regard to recognised professional standards and practices.”²⁴ In compliance with the legislation, the Auditor-General chooses to conduct all audits in accordance with Australian Auditing and Assurance Standards (AUS). However, as compliance with the AUS is mandatory for members of the Australian Society of CPA and the Institute of Chartered Accountants in Australia through the professional standard, APS 1.1 “Conformity with Auditing Standards”, the Auditor-General has little flexibility in practice as to which “professional standards and practices” to apply.
- 2.52 There is a formal commitment to harmonise the Australian auditing standards with the international standards by 2005.²⁵
- 2.53 Financial audits are conducted on a fee for service basis paid by the agencies. Where an agency is a controlled entity, these fees are paid by the parent entity. The level of fees depends on the time taken and the seniority of staff performing the audit.

Compliance and performance audits

- 2.54 Financial auditing is only part of the role of the Audit Office. It also undertakes sample audits of a number of agencies to assess the level of compliance with such things as guidelines for the appropriate use of credit cards or consistency with recommended procurement practices. The Audit Office also undertakes performance audits which assess the effectiveness and efficiency of particular activities.
- 2.55 The financial audit fee charged to each agency annually by the Audit Office covers the agency’s annual financial audit, any compliance audits performed on that agency, and a mark up for the general shortfall in the actual cost of performance audits compared to funding received from NSW Treasury. In 2002-03 the Audit Office received \$2.7 million towards both the cost of performance audits, and the cost of reporting to Parliament.²⁶

²³ Audit Office of NSW *Annual Report 2003*, p 10

²⁴ Section 27B(4) (a)

²⁵ Audit Office of NSW *Contract Audit Agents Manual*, 2003, p42, Australian Accounting Research Foundation *Compatibility between International Standards on Auditing and Australian Auditing and Assurance Standards*, Guidance Note, July 2003

²⁶ Audit Office of NSW *Annual Report 2003* p 42

- 2.56 The Committee is not questioning the suitability of these arrangements although it could be argued that the mark up for performance audits means that small agencies are effectively subsidising the performance audit costs of larger agencies. This could be argued because all agencies are charged the performance audit mark up through their financial audit fee, but performance audit costs are likely to occur on larger agencies. This is discussed further in Chapter Four.

Issues affecting small agencies' audit fees

- 2.57 In its submission, the Audit Office stated that there are fixed costs for every audit, but that these are "difficult to quantify" as the underlying cost drivers (such as the type of agency, the nature of its operations etc) vary with each agency. This means that the activities that must be performed on every audit will cost each entity a different amount as each agency has different characteristics. The Audit Office has advised that, in order to conform with both the auditing standards and the PFAA, the following activities must be performed on every audit, regardless of the size of the agency:

- issue an engagement letter;
- ensure the quality of the audit process through appropriate supervision;
- properly document the audit for instance through plans, programs and evidence;
- review annual reports to confirm that disclosed information is consistent with the audited financial report;
- obtain representations from management (usually in the form of a letter);
- investigate subsequent events;
- test the "going concern" assumption;
- issue an Independent Audit Report;
- issue a Statutory Audit Report to the Minister, Treasurer and agency head; and
- report to Parliament.²⁷

Materiality

- 2.58 As noted above, the Audit Office is required by Australian Auditing Standards and the PFAA to express an opinion on whether each agency's financial report materially presents in accordance with applicable Australian Accounting Standards, and complies with section 41B (for statutory bodies) or 45E (for departments) of the PFAA.
- 2.59 An error in an agency's financial report is "material" if, in the auditor's opinion, it could adversely affect decisions made by users of the financial report. In deciding what is material for each agency, the Audit Office is required to consider the nature and amount of transactions entered into by that agency.²⁸ As the nature and amount of transactions vary across agencies, the Audit Office will have a unique expectation of what is material for each agency.
- 2.60 The Audit Office considers this materiality expectation when determining the nature, timing and extent of the audit procedures to perform on each agency's financial audit. As smaller agencies tend to process a smaller dollar value of transactions, they will generally speaking have a lower level of materiality. This means that when performing the audit of a small agency, the auditor will often spend a great deal of time

²⁷ Correspondence from Mr R J Sendt, Auditor-General, to the Committee Chairman, 22 October 2002

²⁸ Australian Accounting Standard 5 "Materiality", paragraph 4.1.3

performing audit procedures on transactions that may be considered immaterial in a larger agency. For instance, \$10 million may not be material to the accounts of the Department of Education but it is larger than the entire income of some other agencies. This may give the appearance of inefficiency in determining that the accounts of small agencies are materially correct.

Factors impacting on the extent of audit procedures

2.61 A further consideration is that the effort required to audit an agency is not necessarily proportional to the size of the agency. Factors that can impact on audit effort include:

- The strength of the internal control systems. Smaller agencies generally have weaker systems of internal control than larger agencies so that auditors cannot take as much reliance on them for audit assurance. As a result auditors may be required to rely more on time consuming substantive testing procedures (such as manually testing a sample of transactions).²⁹
- The complexity of the operations within agencies. The greater the complexity of the activities performed by an agency, the greater the extent of audit effort required. Conversely the simpler the record keeping systems utilised by agencies, the greater the audit effort that may be required. Small agencies would tend to have less complex operations, but also simpler record keeping systems, than large agencies.³⁰
- The extent of financial auditing resources and expertise. Smaller agencies do not have the resources or financial expertise of larger agencies and as a result may need more audit assistance than large agencies.³¹
- Audit fees for small public sector agencies could also be higher than for small private sector reporting entities because of higher levels of accountability expected of the public sector. The International Standard on Auditing 320 in relation to materiality includes a special proviso that:

In the public sector, materiality is also based on the context and nature of an item and includes for example sensitivity as well as value. Sensitivity covers a variety of matters such as compliance with authorities, legislative concern or public interest.³²

Conclusion

2.62 The reporting and auditing requirements for departments and statutory bodies were established by Parliament in order to provide the public with information about the performance of public sector agencies. These are based on the standards developed by the auditing and accounting professions. Based on the evidence received by the Committee, these requirements are very inflexible for small public sector agencies.

²⁹ Mr Tony Whitfield, Deputy Auditor-General, transcript of hearing, page 40

³⁰ AGS 1048, "The Special Considerations in the Audit of Small Entities", paragraphs 5, 11, 12

³¹ Mr Lee White, Assistant Auditor-General, transcript of hearing, page 42

³² International Standards on Auditing p265 downloaded from www.ifac.org/publicsector

Chapter Three - Extent of the Compliance Burden

- 3.1 As noted in Chapter One, as a first step in this inquiry, the Committee of the previous Parliament released a discussion paper to promote debate about reporting and auditing requirements for small agencies. The paper raised theoretical questions about the purposes of reporting including:
- Who were the users of financial information about small agencies?
 - Did the public need to know the detailed financial information about very small agencies?
 - Was there any benefit in reducing the level of scrutiny of these agencies?
- 3.2 Specific information about the costs of annual reporting and auditing were also sought.¹
- 3.3 This Chapter discusses the evidence presented to the Committee about the extent to which complying with accountability requirements has been burdensome for small agencies in New South Wales. This was drawn from the 13 submissions made in response to that discussion paper and in the subsequent public hearing.
- 3.4 It discusses the costs of preparing financial statements and annual reports to Parliament and the costs of auditing these statements. In one case, the State Council of Rural Lands Protection Boards, the cost of accountability to Parliament rather than to the Minister can be directly compared.

Views of submissions

- 3.5 In summary, the Committee was not presented with many instances that reporting and auditing requirements were burdensome. Of the 13 submissions in response to the discussion paper, only five raised concerns about the current reporting arrangements for either their agency or some of their controlled entities. These were from:
- The Hon Richard Amery MP, then Minister for Agriculture (covering a range of portfolio statutory bodies);
 - State Council of Rural Lands Protection Boards (covering the concerns of 48 boards);
 - Department of Gaming and Racing (in relation to two agencies);
 - NSW Health (raising issues about 11 agencies); and
 - Wollongong Sportsground Trust.
- 3.6 Two Ministers made submissions in support of the current arrangements for their portfolio bodies. These were the Hon John Watkins MP, then Minister for Education and Training, and the Hon Kim Yeadon MP, then Minister for Information Technology, Energy, Forestry and Western Sydney. An anonymous submission (Submission 1) recommended restructuring agencies where appropriate, but emphasised the importance of accountability for public money. The then Privacy Commissioner pointed out that any changes to the *Public Finance and Audit Act 1983* (PFAA) would have consequential effects on the State Privacy Act as many agencies were only

¹ PAC Discussion Paper pp 4-6

covered by privacy requirements by virtue of their requirement to be audited by the Auditor-General.²

- 3.7 The remaining submissions were from NSW Treasury, the NSW Audit Office, CPA Australia and the Office of the Auditor-General of Queensland. These raised more general points about possible ways of addressing concerns about the level of compliance costs.
- 3.8 Of the five submissions concerned about current arrangements, actual costs were of less concern than the question of whether they should be required to report to Parliament at all. This was either because the funds under consideration were not from the Consolidated Fund or because the size of entity's income was so small.³
- 3.9 There was more concern in submissions and evidence about the extent of audit fees particularly where these could be compared to private sector auditing.

COSTS OF REPORTING

- 3.10 The Committee was not presented with much evidence about the cost of preparing financial and annual reports. The Agricultural Scientific Collections Trust estimated that the staff costs of preparing financial statements were in the order of a week's work (estimated at \$1,200) and annual report preparation was around two days of staff time (around \$480) although this did not include production costs for the reports.⁴
- 3.11 The Department of Gaming and Racing submission noted that preparation of the three reports for the department and two controlled entities, the Liquor Administration Board and the Casino Community Benefit Fund, cost around \$15,000 in printing costs but estimated that the pre-production costs were in the order of \$150,000.⁵
- 3.12 The Department of Health submission noted that the department controls nine small professional registration boards which report separately. There are also two small agencies, the Health Foundation and the Institute of Clinical Excellence, which at that time were not included in the Department's accounts. The submission noted that the Health Foundation, a trust for receiving bequests, produced only 70 annual reports in 2001-02 of which 45 were provided to Parliament. Few inquiries have been received about the Foundation. In the public hearing the Chief Financial Officer described the costs of printing annual reports but had not quantified the cost of report or statement preparation:
- Mr BARKER:** In terms of efficiency and effectiveness, the printing costs associated with producing those documents vary from about \$196 for the Health Foundation, which has the smallest distribution, to about \$4,600. In addition to the printing costs there are the costs incurred in producing the documents.⁶
- 3.13 The greatest level of concern was expressed by the State Council of Rural Lands Protection Boards which coordinates and advises 48 separate rural lands protection boards. The boards were required to prepare financial reports in accordance with the

² Submission No 3, Submission No 8, Submission No 1, Submission No 2

³ eg Submission 6, former Minister for Agriculture, attachment 3 "Statutory Authorities Overseen by the Economic Services Unit of NSW Agriculture.

⁴ Submission No 6 attachment 2, Agricultural Scientific Collections Trust

⁵ Submission No 11, p 4

⁶ Mr Ken Barker, Chief Financial Officer NSW Health, transcript of hearing p 17

Public Finance and Audit Act 1983 for the first time for the 2002 reporting period. Prior to this, reports on board activities were made to the Minister. The new requirements meant that the boards had a much shorter period in which to prepare statements.

- 3.14 Mr Steve Orr, the Chief Executive of the State Council, explained the difficulties faced by the boards in adjusting to the new arrangements and, in particular, the new deadline:

Mr ORR: The preparation of accounts largely came back to the fact that under our former arrangements under the *Rural Lands Protection 1989* we had up until 30 March to submit our financial statements. There was a lot of concern about the approach which the Auditor-General was going to take within boards, and they went to a lot of trouble to ensure that their accounts were spot on. That issue, plus the fact that our time frame had been cut in half—we had to submit our financial statements within six weeks—necessitated a lot of boards getting extra help from an accountant to prepare and ensure that the financial statements were spot on before they were sent in. That brought about a cost, as you can see, which is quite significant from our perspective. I do not know whether the cost will be the same next year but I imagine it would not be as great given that we have been through the process once, but it will still be there given that the time frame has been reduced by six weeks.⁷

- 3.15 A key reason of the increased costs was the level of skills available in small agencies:

Mr ORR: In terms of preparation costs, a lot of it relates back to the ability of the individual administrative officer some of whom have very good financial management qualifications and experience and others do not. In those instances the boards felt that it was appropriate and prudent for an accountant to give them a hand. It varies across the board system.⁸

- 3.16 In many cases this work was contracted to external accountants because this coincided with the period in which boards were calculating rates and distributing notices to rural land holders. However, because of the financial year finishing on 31 December, external accounting resources could also be in short supply in some areas. In their submission, the State Council estimated that the cost of financial report preparation by the boards had increased from \$57,000 to \$159,000 as a direct result in these changed arrangements. This is an increase of 181%.⁹

NEED FOR AGENCIES TO REPORT

- 3.17 Concerns in relation to the requirement for agencies to prepare reports for Parliament fell into three broad types:
1. A theoretical concern that agencies did not receive funding from the Consolidated Fund so should not be required to report;
 2. A technical concern that a particular agency did not need to report under the current requirements; and
 3. A recognition that some arrangements are outdated and should be reviewed.

⁷ Mr Steve Orr, Chief Executive Officer State Council of Rural Lands Protection Boards, transcript of hearing p 3

⁸ *ibid* p 4

⁹ Submission No 9, p 3

Public Money

3.18 As noted above, in the discussion paper circulated at the beginning of this inquiry, the Committee asked for comments on the audience of agencies' financial reports and the level of interest in their contents. In response to these questions, a number of submissions queried whether there was a need for reports to be made to Parliament and indeed whether they could be understood by the general public.

3.19 For instance, the Wollongong Sportsground Trust stated that:

Some Trustees would argue that the current regime of regular financial reporting to Treasury, in the Trust's case monthly, provides a far more rigorous and disciplined management environment than having to produce an annual financial report that few members of the public could understand or draw any sensible conclusions from.¹⁰

3.20 Two submissions, from the State Council of Rural Lands Protection Boards and from the statutory bodies within the Agriculture portfolio, queried whether there was a need to report to Parliament as the statutory bodies in question raised funds from certain sections of the community and should instead be accountable to these people.

3.21 This view was also stated in evidence to the public hearing, where Mr Nick Milham of NSW Agriculture said:

Mr MILHAM:The bodies are 100 per cent funded by their constituents through compulsory charges. A comment was made before about their being industry funded. They manage their own affairs without any intervention in their activities from within NSW Agriculture or government generally except insofar as we have an oversight function to ensure that they do not step outside the constraints of the legislation.¹¹

3.22 Mr Steve Orr, of the State Council of Rural Lands Protection stated:

Mr ORR: We have often struggled with the question of why were the boards put under this arrangement to begin with. The Minister for Agriculture issued a press release in 1996 and explained an array of changes to the board system and talked about accountability with respect to Rural Lands Protection Boards and stated:

I fully support the development and implementation of proper management, strategic and operational plans by all Rural Lands Protection Boards. Provisions making it compulsory for boards to have such plans in place will be included in the new RLP Act. RLPBs must come under the Public Finance and Audit Act as they are handling public moneys. A provision relating to this will be included in the new Act.

Our interpretation of the definition of public moneys as per the Public Finance and Audit Act does not cover the money which we handle, so there is an inconsistency in terms of the definition within the Public Finance and Audit Act as to what is "public money" and what we handle. In our opinion we do not handle "public money" as per the definition in the Public Finance and Audit Act.¹²

3.23 The Health Department's submission also noted that the primary audience for information about the nine professional registration boards administering registration fees is the professional groups they represent. It also noted that there was very little public interest in the Health Foundation.¹³

3.24 This view is of particular importance given that some of these agencies have few assets, low budgets, and low risk of failure. It could be queried whether the effort and costs involved in preparing general purpose financial statements for such small

¹⁰ Submission No 13 p 2

¹¹ Mr Nick Milham, NSW Agriculture, transcript of hearing p 13

¹² Mr Steve Orr, transcript of hearing p 4

¹³ Submission No 12, p 1

agencies is justified by the low level of interest indicated in the evidence from NSW Health and the small amount of money involved.

- 3.25 The Committee notes that despite this low level of interest, each professional registration board is likely to meet the definition of a “reporting entity” as defined in Chapter Two, because the professional groups they represent would be considered to be “users” of the registration boards’ financial reports under Australian Accounting Standards. This means that even if the boards did not administer “public money” as defined in the PFAA it could be argued they should still prepare general purpose financial reports.
- 3.26 However, the PFAA provides that all money controlled by statutory bodies is “public money” for the purposes of the Act irrespective of whether or not Parliament provided the funds. Section 4 of the Act defines “public money” to include:
- (a) securities and all revenue, loans and other money whatever, collected, received or held by, for, or on account of the State, and
 - (b) without limiting the generality of paragraph (a):
 - (i) money which, pursuant to any Act, is directed to be paid to or expressed to form part of the Consolidated Fund or the Special Deposits Account, and
 - (ii) such money, or money of such class or description of money, as is prescribed for the purposes of this definition.
- 3.27 Treasury and CPA Australia also expressed the view that, irrespective of the apparent low level of interest in particular agencies, there was an overriding expectation in the public that public agencies be accountable. This accountability expectation supports the view that small public sector agencies such as the boards are “reporting entities” under Australian Accounting Standards that should prepare general purpose financial reports.
- 3.28 The reasons for this expectation of accountability in the public sector, regardless of the size of agencies, were elaborated to the Committee by a witness from NSW Treasury:
- Mr NEALE:** All moneys that come within the control of State government entities are basically public moneys. There is a community expectation that the highest level of accountability will be imposed on the use of those moneys. We find in government that the Auditor-General will raise issues in his reports that in our view are quite insignificant. However, the public interest in those items can be considerable—probably beyond what is required given the incidents involved. We find that that happens quite a lot. We try to concentrate on material items—the accounting standards try to convey that impression as well. When the Auditor-General is doing his audits he also tries to focus on materiality. It is not as though we want every cent to be accounted for. However, there is certainly a community expectation that when moneys are in State government hands they will be administered with the highest integrity. Whenever there is a breach of that integrity it creates a lot of community concern.¹⁴
- 3.29 Witnesses from CPA Australia also expressed the view that the current arrangements ensure that there are adequate safeguards in place to inform the public about the use of public money. One of their witnesses told the Committee:
- Ms Carol:** As is highlighted in our submission, CPA Australia believes that the current financial reporting framework in place for public sector small agencies ensures there is accountability and transparency in the reporting process. This reporting framework

¹⁴ Mr Ian Neale, NSW Treasury, transcript of hearing, p 34

requires management of public sector agencies to prepare a financial report. It also requires an audit to be performed. Without the right governance structure and reporting framework, the process lacks checks and balances, and ultimately the users will lose confidence in the reporting. CPA Australia believes there are many and varied users of audited financial reports for public sector small agencies. Clearly parliamentarians form part of the governance structure. In addition, the general public are also considered users. Without the need for these agencies to be held accountable, financial reports may lose their relevance, reliability and comparability.¹⁵

- 3.30 The Committee notes the concerns of agencies about the need to report but considers that the requirement reflects legitimate public interest in their performance. This public interest exists regardless of whether agencies are dependent on the Budget for funding, are Public Trading Enterprises or are subsidiaries of agencies. The Committee considers that the principle purpose of preparing financial reports is to ensure both financial transparency and accountability by informing the public, through the Parliament, about the performance of agencies in the State Sector so that appropriate decisions can be made
- 3.31 Chapter Four explores some options for reducing agency reporting requirements.

The Legal Structure of Agencies

- 3.32 The legal structure of agencies can arguably result in unnecessary reporting requirements. In the submission from NSW Health, the Committee was told that the Audit Office had formed the view that the Health Administration Corporation, which has no purpose outside of the operations of the NSW Department of Health, should prepare separate accounts for auditing, and separate annual reports.¹⁶ In the public hearing, Mr Ken Barker, the Chief Financial Officer explained the issue further:

Mr BARKER: We also have the Health Administration Corporation [HAC], which is a corporation sole. We have never done a separate set of financial statements or an annual report for the corporation; we refer to it in the department's annual report. However, the Auditor-General's Office recently took the position that it believes the corporation should be subject to the same rigour as other bodies. The way that Health works is that many assets are in the name of HAC but all of those assets are effectively reported in the Department of Health consolidated financial statements. So we believe it is perhaps bureaucracy going a bit crazy to require another set of financial statements for an organisation that is effectively a corporation sole.¹⁷

- 3.33 The Committee asked Mr Barker why the Audit Office considered that it should prepare separate accounts:

Mr WHAN: ...the Health Administration Corporation [HAC]...was established by an Act in 1982 but previously has been audited as part of the Department of Health. The department's submission states that, "it has been determined that technically HAC is a statutory body referred to in section ... and is required to prepare separate accounts and annual reports". Obviously they are resisting doing that. You may not know about that specific case but if you can get all that information in a single report from the Department of Health is there a rationale, apart from the fact that it is established by separate statute, as to why you would require them to do a separate audit of that organisation?

¹⁵ Ms Naomi Carrol, CPA Australia, transcript of hearing, p 23

¹⁶ Submission No 12, p 2

¹⁷ Mr Ken Barker, NSW Health, transcript of hearing, p 16

Mr WHITFIELD: We do not require them; the law does because it was set up as a separate entity. If they were not under that particular Act, if it had been the way it was previously we would have continued auditing them.

- 3.34 The Committee discussed whether the requirement to separately report was considered at the time the legislation was passed to establish the HAC:

Mr WHAN: Presumably none of this was considered when the legislation was passed to set it up?

Mr BARKER: Annual reporting was a little different in the early 1980s which is when the HAC came into being. Certainly the formal content of annual reports has expanded considerably over the years. I know I have some in my office which pre-date me and accountants have a tendency to live on in agencies and they are virtually just a set of financial statements. It would appear in the 1930s they did not need much.

- 3.35 Given the apparent lack of flexibility in current Accounting Standards and legislation, the most feasible way for the financial reporting burden of the HAC to be removed, seems to be for the responsible Minister to change the legal structure of the NSW Health Department. While the Committee accepts that this may not be a simple process, it reflects their view that it is up to Ministers to ensure that the legal structure of the agencies under their control remains appropriate.
- 3.36 The Committee considers an optimal structure for an agency to be one that enables the efficient delivery of services, but at the same time provides for adequate and cost effective accountability to Parliament. Individual financial reports produced at the entity level enable Parliament to assess performance at a much more detailed and meaningful level, than highly aggregated reports, thereby making their oversight more effective. At the other extreme, a very disaggregated structure may lead to Parliament being provided with such detailed information, that accountability is hampered so that the benefits of reporting are outweighed by the costs.
- 3.37 While the structure of agencies should primarily be determined on the basis of the functions that they perform, the cost and desirability of reporting can be very significant for small agencies. Given that there will always be a minimum reporting and auditing cost, these costs will become increasingly significant the smaller the organisation. As noted elsewhere in this report, the Committee considers that it is Parliament's responsibility to determine what structure is suitable taking into account the services that the agency delivers, the cost of reporting and accountability.
- 3.38 The Committee notes with concern that such an issue could arise within the administrative arrangements of agencies. However it is apparent that this situation was later resolved as, in a report to Parliament subsequent to the hearing, the Health Administration Corporation was not audited separately.¹⁸

Historical Arrangements

- 3.39 In two submissions, the Committee was told of small government agencies where separate reporting had been established in the past but is now considered inappropriate.
- 3.40 The first small government agency considered, the Liquor Administration Board (LAB), is administered by the Department of Gaming and Racing (DGR). The DGR submission suggests that the reporting requirements for the LAB are inefficient and

¹⁸ NSW Auditor-General's Report to Parliament for 2003, vol 5

meaningless. The LAB was established as a “department” included in Schedule 3 to the PFAA, and formerly received an allocation from the Consolidated Fund. While the LAB is still listed in Schedule 3 to the PFAA, the funding arrangements have changed. The 2002-03 Annual Report for LAB states that:

All costs of the Board are met by the Department of Gaming and Racing from annual appropriations to the Department of Gaming and Racing from the Consolidated Fund.¹⁹

- 3.41 Despite the new funding arrangements, LAB is still required to prepare a separate financial and annual report. DGR’s submission states that :

...the Statement of Financial Position (Balance Sheet) does not show any assets, liabilities or equity. The Operating Statement (Income and Expenditure) shows only the value of notional support given by the DGR.²⁰

- 3.42 This reflects the fact that the financial statements only reflect the notional value of support provided to the LAB by DGR:

The LAB itself consists of 4-5 magistrates (who are Licensing Magistrates). As a separate entity it had no costs that it could report as those particular costs (of the magistrates) are incorporated in the financial report of the Attorney General’s Department.

It is not possible for users to obtain the real costs of running the LAB at present. To present financial statements in their current form is quite meaningless, as this information is already contained within DGR’s report.²¹

- 3.43 Given the evidence supplied by the DGR, the Committee questions whether the LAB should continue to be listed in Schedule 3 of the PFAA as a Department. If the LAB was removed from Schedule 3 but continued to have a separate legal existence, and control of it was transferred to another agency (for example DGR), it would not need to prepare a separate annual report. As a controlled entity of another agency, it would still however have to prepare separate financial reports, which would then be consolidated with that of the parent agency.
- 3.44 Alternatively, if the functions performed by the LAB were transferred, through legislative change, to another agency so that it no longer had a separate legal existence, the LAB would not need to prepare a separate financial report or annual report, as its functions would be reported within the new agency’s reports. The cost of such alternative arrangements is less detailed reporting and auditing, and arguably therefore less accountability. Ultimately, as with the HAC above, it is up to the appropriate Minister and Parliament to consider which arrangements are appropriate.
- 3.45 The second small government agency referred to the Committee, the Agricultural Scientific Collections Trust, is a controlled entity of the Department of Agriculture (now the Department of Primary Industries). The Trust is required to prepare separate financial statements which are audited by the Auditor-General by virtue of its inclusion in the “invited audits” list in the regulations.²² The Committee notes that as an entity controlled by an agency listed in Schedule 3 of the PFAA, the Trust is also required to prepare separate financial statements through section 45(1A) of the PFAA.

¹⁹ Liquor Administration Board 2002-03 Annual Report, p 60

²⁰ Submission No 11, p 2

²¹ Submission No 11, p 2

²² Public Finance and Audit Regulation, 2000, section 20

- 3.46 According to the then Department of Agriculture's Annual Report for 2002-03, the Trust's own legislation, the *Agricultural Scientific Collections Trust Act 1983*, also requires the preparation of separate general purpose financial reports.²³
- 3.47 The Trust was established to give statutory protection to biological collections maintained by the Department. There are currently two collections managed by the Trust: the insect and mite collection and the plant pathology herbarium. Excluding notional income of about \$317,000 for staff provided free of charge to the Trust by the Department, the 2002-03 financial report for the Trust records a very small income of some \$20,000. The estimated replacement value for the collections is \$24 million.²⁴
- 3.48 The financial statements of the Trust do not include a value for the collections, as it has not been possible to develop a reliable valuation. It is understood that the non-valuation of collections is permitted practice under Australian Accounting Standards in these specific circumstances. Because of the extremely low level of income and the exclusion of the collections, the financial statements of the Trust report to the nearest whole dollar amount rather than, as in most agencies, to the nearest thousand dollars.²⁵
- 3.49 The services provided to the Trust by the Department include the accommodation of the collections, paying the salaries of Trust staff, and preparing the Trust's financial reports. The Committee notes that despite the Trust recognising notional income of \$317,000 for the provision of these services, this may not be a reliable estimate of their value according to note 1 of the Trust's financial report for the year ending 30 June 2003:

It is not possible to reliably estimate the total value of material expenditure incurred by the Department in direct support of the Trust. This is due to the number of staff located throughout the State that have some input into the maintenance of the collections and the interrelationship with normal departmental duties. However, salary costs related to the staff located in the Trust building in Orange are recognised in the Statements...²⁶

- 3.50 The Committee also notes that despite the uncertainty of the "notional" income, the Audit Office issued an unqualified opinion on the Trust's financial report.
- 3.51 The reasons for establishing the Trust were described to the Committee by the Trust's Director, Dr Murray Fletcher:

Dr FLETCHER: In 1983, when the Act was passed, an account was set up in Treasury called the trust fund. It received an allocation of \$15,000 as an E item in Treasury; it was a protected item. It no longer has that status, all the E items have been removed from Treasury. It now comes in with a B classification, it is sort of irrelevant but is still \$15,000 20 years later. The Minister at the time assured Parliament it would cost no more to run this account in future than it did at that time. The \$15,000 allocation we still receive comes through the department and is put into that account. We also raise funds through the sale of cultures. We maintain a living culture collection of fungi and bacteria, both of which are plant pathogenic. The income from that in the past 12 months was about \$4,000.²⁷

²³ Department of Agriculture Annual Report 2002-03, p 47

²⁴ Mr Tony Heffernan, NSW Agriculture, transcript of hearing, pp 9-10

²⁵ Submission No 6, Attachment 2, Agricultural Scientific Collections Trust, p 1

²⁶ Financial Report of the Agricultural Scientific Collections Trust, 2002-03

²⁷ Dr Murray Fletcher, Agricultural Scientific Collections Trust, transcript of hearing p 10

Chapter Three

3.52 There has been no indexation of the original \$15,000 grant which, in any case, bears no relationship to the actual costs of running the Trust.

3.53 Dr Fletcher described the need for the Trust:

The Trust Act vested ownership of the collections in a six-member trust.... They own the collections that are covered by the Trust Act. That ensures that any decision at the whim of anyone in the hierarchy of the department who might decide to dispose of the collections would have to go through Parliament.²⁸

3.54 The Committee notes the importance of the collections as an agricultural resource. However it seems inefficient and meaningless for separate audited accounts to be required when they may not accurately reflect the costs of the Trust, and the major assets which they administer are not recognised. As with the other small agency examples considered above, the Committee recommends that the appropriate Minister review the appropriateness of the legal structure of the Department and the Trust, taking into consideration Parliament's expectation for proper accountability, and the burden on small agencies of having to report.

Conclusion

3.55 The Committee notes that there is some evidence that reporting requirements for some very small agencies may not be the best allocation of public resources. However the Committee also notes that there is very little flexibility in either Australian Accounting Standards, or in current legislation relevant to NSW Government agencies to reduce the reporting obligations of small agencies. To ensure that the administrative burdens of small agencies are reasonable, the Committee considers that the appropriate Ministers should review and update the legal structure of the agencies within their portfolio to ensure they remain optimal. This is discussed further in Chapter Four.

3.56 The Committee is unable to draw firm conclusions about the extent of reporting inefficiencies faced by small agencies, based on the limited information available to it.

COSTS OF AUDITING

3.57 The evidence presented to the Committee overall indicated that agencies were more concerned with the cost of having their financial reports audited than the cost of preparing the reports. This is probably partly because the Auditor-General charges agencies for this work so auditing costs are more visible. Of particular concern to agencies were:

- examples of fees being a considerable proportion of an agency's income;
- examples of recent increases in audit fees;
- lower costs of private sector auditing;
- lack of priority for auditing smaller agencies from the Audit Office; and
- apparently similar agencies audited in another state having lower audit fees.

²⁸ Dr Murray Fletcher, transcript of hearing p 11

High costs of audit

3.58 The Committee was provided with some examples of agencies where the cost of audit was a significant proportion of the income of the agency.

3.59 Witnesses from the Department then called NSW Agriculture told the Committee that the audit fee for the Agricultural Scientific Collections Trust in 2001-02 was \$3,190 which reflects about 20% of the Trust's income from a \$15,000 grant.²⁹ The Committee considers this proportion to be too high as a proportion of its income, particularly as, a witness told the Committee that these funds are audited as part of NSW Agriculture's audit because the Trust is a controlled entity of the Department:

Mr EVERETT: The agricultural scientific collections trust is a controlled entity of NSW Agriculture. It is run as a project within the costing system of NSW Agriculture. The internal controls of NSW Agriculture apply to the trust, and it is treated as if it were any other project within NSW Agriculture. As far as the treatment of the financial statements, they are audited on a global basis when NSW Agriculture statements are audited.

CHAIR: Are you suggesting to the Committee that the trust is audited twice, initially as a trust and then when aggregated?

Mr EVERETT: Yes. It is a subset of NSW Agriculture. The transactions of the trust are probably not directly audited because of the small number of transactions and the small dollar value of them. When the audit opinion is given for NSW Agriculture it is all-encompassing when the collections trust is taken into account. The audit is done on a very professional basis by the Audit Office. Given the costs involved, it is debatable whether we may be able to do it a little more economically.³⁰

3.60 The NSW Health submission noted that the Health Foundation's audit fee of \$5,000 in 2001-02 was some 27% of the cost of service for the Foundation excluding depreciation of assets and insurance costs.³¹

3.61 The submission from NSW Agriculture stated that the audit cost of \$1,600 for the NSW Dried Prune Industry Marketing Committee was 21.7% of its annual income of \$7,350 in 1999/2000. This Committee was wound up in March 2000.³²

3.62 A witness from NSW Treasury raised the example of the Tomato Processing Board the major annual expense of which was the audit fee:

Mr SMITH: In my days at the Audit Office I had one audit of an agency that had a budget of about \$5,000 a year and five transactions. The biggest individual transaction was the audit fee of about \$200. Ultimately, a sensible decision was made that the board should merge its activities with another entity.³³

3.63 There did not seem to be a large number of such examples. As a witness from Treasury stated they are generally not excessive:

Mr NEALE: As Martin said, we have found in the past that audit fees are not an exorbitant cost on agencies. They are declared in their accounts each year. We think it is a

²⁹ Dr Murray Fletcher and Mr Allan Everett, transcript of hearing p 17

³⁰ Mr Allan Everett, transcript of hearing, p 11

³¹ Submission No 11, p 2

³² Submission No 6 Attachment 3, Statutory Authorities Overseen by the Economic Services Unit, p 7

³³ Mr Martin Smith, transcript of hearing p 35

necessary cost. When one is involved in running financial affairs one is audited and one pays for an auditor.³⁴

Recent increases in fees

3.64 Mr Ken Barker, the Chief Financial Officer of NSW Health, stated in evidence to the Committee that audit fees for some agencies in the Health portfolio had increased in the past year, in some cases quite significantly:

Mr BARKER: In preparing for today's hearing we extracted some information on audit fees, and it is becoming interesting. In 2000-01 the registration boards had audit fees of \$9,100. In 2001-02 they increased to just under \$30,000 and for the year just finished—2002-03—they increased to \$33,264. In 2000-01 the Health Foundation, which is one of the reports that I have tabled, had audit fees of \$4,500, \$5,000 in 2001-02 and up to \$6,000 in 2002-03. I think that is not a reasonable amount of money in terms of the Health Foundation because the number of transactions in that account is very small. It is not as though it is an account with a high volume of transactions. Like all external audit processes there is a reliance on internal audits and how these things go through the overall system. They are significant increases when you consider the costs in 2000-01.³⁵

3.65 Mr Barker later commented that he did not think this increase was justified and that the Health portfolio was holding discussions with the Audit Office about this level of fee increase.

3.66 Mr Barker was concerned about the level of service provided by the Audit Office in relation to the Foundation and the lack of control the Health department had over these costs:

Mr BARKER: The Audit Office assesses the time and effort that is put in to audit those boards and it sets the fees accordingly. The Audit Office is the sole auditor. To date agencies have had to pay for what has been sought.

CHAIR: Have they sought too much?

Mr BARKER: We are having some discussions with them now about their current proposed fees which, as I said, have gone up 20 per cent for the Health Foundation compared to the figures for last year. Government is expected to increase the cost structure. The general answer—and remember that this is for normal cost increases—is that we have not asked for anything exceptional. In my view it would be well outside the cost structure under which many government agencies are expected to operate.

CHAIR: Is it the costs they are charged or the over-servicing that creates these high costs?

Mr BARKER: It could be a combination of the two. If they believe they have got to put in an unwarranted effort, it is a combination of the two. It is potential overservicing which is then reflected in their cost structure. I know that some time ago before this Committee the Audit Office argued that it was more cost-effective than private sector auditors. In fairness to them, some of our health services actually does contract out that audit work to audit firms, including any of major multinationals. Whilst they still do some of it, they audit some of it out. What is always interesting in this area in an agency perspective is that we have no choice in the matter. We cannot even market test because of the way it gets reported back to Parliament. As I said, we are having some discussions with them about their 02-03 charges.³⁶

³⁴ Mr Martin Smith, transcript of hearing p 35

³⁵ Mr Ken Barker, transcript of hearing p 17

³⁶ *ibid* p 20

Comparison to private sector audit services

- 3.67 Mr Barker's comments about the Department's lack of ability to market test auditing services is similar to the concerns of the State Council of Rural Lands Protection Boards. The boards told the Committee that under previous arrangements, most boards were able to procure less costly auditing services and they were more satisfied with the level of communication with their auditors.
- 3.68 Until the audit of the 2002 accounts, each of the 48 boards arranged for their audits to be performed by local private sector accounting firms. After the inclusion of the boards in Schedule 2 to the PFAA, the Audit Office arranged for boards' audits. The majority of the boards were placed into seven groups with auditing services contracted for each group. This meant that smaller local firms were not always able to tender for the work.³⁷
- 3.69 Tony Whitfield, the Deputy Auditor General described the process of selecting auditors for the boards:

Mr WHITFIELD: In respect of the rural lands protection boards we chose to retain four of the 48 and we contracted out the other 44. We put them out to tender with anyone in the area able to tender. The New South Wales council worked with us in going through that tender process. We then appointed a number of agents and the audits went out to them. One of the issues that arose prior to our getting them was that local accountants were doing both the accounting and audit work, which is not permitted under the auditing standards. When we put them out to tender we made it known to the locals that they had a choice—if they wanted to keep the accounting work they would be precluded from tendering for the audit work because there needed to be independence and separation.

- 3.70 The Committee notes that the Audit Office does not select contractors exclusively on the basis of price. This is because quality is more important than the level of fees. This view is echoed by a witness from Treasury that cheaper audit services are not always adequate to account for public money, or indeed any type of money:

Mr NEALE: Once a body is brought under the umbrella of the Auditor-General that body cannot shop around for cheaper rates. That is one of the problems in the corporate sector. People tend to do that sometimes and they do not get the audit services that they deserve.³⁸

- 3.71 However the Auditor-General's auditing process was more costly in most cases than when the boards engaged private sector firms and most boards faced increased fees. Mr Steve Orr, Chief Executive of the State Council, reported that in the first year, audit fees had increased by 75% from \$170,000 to \$295,000.³⁹ Mr Orr also noted that the audit for the Council itself increased from \$3,000 to \$10,000 and did not seem to be as thorough as previous audits.⁴⁰ He stated:

Mr Orr: The worst case with respect to the increase in the audit costs was the Milparinka board which is our smallest board in terms of ratepayer numbers but one of the biggest boards in terms of land area. Their audit costs were approximately \$900, about \$25 per ratepayer, and now it is approximately \$6,000, or about \$150 per ratepayer. Their total budget is less than \$100,000 per year, so it is 6 per cent of their total income goes on

³⁷ Mr Steve Orr, transcript of hearing p 5

³⁸ Mr Ian Neale transcript of hearing p 37

³⁹ Submission no 9, p 3

⁴⁰ *ibid* p 5

audit costs and that is impossible to justify to people who are at the moment suffering one of the worst droughts in history.⁴¹

3.72 Mr Rowan Moore, the Chairman of the State Council described the impact of the increased audit fees on the operations of the boards:

The costs that have been imposed represent a significant, if not outrageous, burden on our ratepayers. We have 130,000 ratepayers who are predominantly rural operators. When a significant burden of this nature is imposed at any time in the rural community boards have no alternative but to pass on those costs. It is clear, when looking back over the history of our board system, that there has been no evidence of any mismanagement in the handling of finances and audit procedures. Boards operate in their local communities with eight elected representatives who, in general, closely monitor the activities, financial activities and wellbeing of their boards.

This increased burden that has been placed on the board system is making it difficult for us to put resources in the place that they are so urgently required—that is, in providing services to our ratepayers and the community. After all, our charter is to look after the welfare of our animal health and the land on which our animals graze. There is an alternative way of creating public security in carrying out our financial obligations. Our board system and State Council are aware of their obligations in this area. We bring to the attention of the Committee and to the Government of New South Wales our concerns about recent changes to our board system.⁴²

3.73 In Volume Three of the Auditor-General's Report to Parliament for 2003, the Auditor-General provided a summary the costs for the Boards in comparison to their revenue:

An analysis of the completed 2002 audits shows that the fees charges range between 0.2 per cent and 1.2 per cent of each Board's total assets and between 0.3 per cent and 1.5 per cent of total revenues. The average is 0.5 per cent based on total assets and 0.7 per cent of revenues.⁴³

3.74 The Committee notes that these fees do not seem excessive as a proportion of the income of each board. However the issue is that private sector auditors directly engaged by the boards charged lower fees and that the boards were not expecting fees at this level.

3.75 In 1997, the then principal auditor wrote to the Council's Treasurer about the proposal for the Audit Office be in charge of auditing. This letter implied that the cost of audit services may in fact be cheaper than previous audits:

The objective is not a low cost product but a quality audit performed to the requirements of the profession at a competitive cost.

Your attention is drawn to the District Health Services whereby clients were able to substantially benefit from a general reduction in audit fees when these bodies were placed under schedule 2 of the Public Finance and Audit Act and contracted out. The contract audits were required to produce a cost effective quality audit.⁴⁴

3.76 The Committee notes that under these circumstances, boards could have difficulty planning their allocation of limited resources. As the boards are funded by rural ratepayers, such unexpected increases can lead to increases in the level of rates

⁴¹ Mr Steve Orr, transcript of hearing p 4

⁴² Mr Rowan Moore, Chairman of State Council of Rural Lands Protection Boards, transcript of hearing, p 1

⁴³ Auditor-General's Report to Parliament 2003 Volume Three, p 16

⁴⁴ Correspondence from P K Brown to Mr K Allison Treasurer Rural Lands Protection Boards' Association of NSW, 21 March 1997, appended to submission 14 supplementary submission from State Council of Rural Lands Protection Boards

imposed on landholders. The Committee hopes that there will be less variability in audit fees in future years once the boards have made the transition to the new arrangements.

- 3.77 The Committee understands that a reason why the fees charged by the Audit Office may be more than those charged by the private sector under the previous arrangements, is because accounting and audit work must now be done by different firms. As noted above, for some of the boards at least, the local accountants were doing both the accounting and auditing. As this practice is not permitted under Australian Auditing Standards, the Audit Office ensured that there was a separation of the two functions. A consequence of this separation is that costs increased, because the auditor does not have the same understanding of the board's transactions as board's own accountant. The benefit of the required separation is independence.
- 3.78 The Committee also notes that a private sector audit is not necessarily the same as a public sector audit. For example, upon being included in the schedules to the PFAA, additional audit procedures would be required to test compliance with the relevant legislation. This may also have contributed to the additional costs.
- 3.79 While these factors may have contributed to the increased audit costs, the Committee also notes that the fees charged by the NSW Audit Office seem high in comparison to audit offices in other states. This is considered further below.
- 3.80 Potential responses to address the compliance burden of small agencies are discussed in Chapter Four.
- 3.81 Another key concern for the boards was the quality of communication and service provided by the auditors under the new arrangements:

Mr ORR: Yes, it is. Our costs have increased by \$130,000. We believe that the amount of time spent on site by auditors has reduced. Honourable members might say that that is part of the process and as long as they have done their job that does not matter. We believe there were issues regarding the audit process this time. If this arrangement is to continue those issues must be addressed. I will run through some of the points raised. About 90 per cent of boards felt that the audit was not value for money and that the cost was an inappropriate use of ratepayers' money. As I said, the cost for some boards has reduced, so that is why it is not 100 per cent. Many boards reported that the audit process was disorganised and deemed by many to be a failure. Forty boards reported that no pre-audit Interview was conducted, and that was a requirement. Many boards reported that they did not receive a client plan of how the audit was to be conducted.

A large number of boards felt that the communication between the Audit Office and the contractors was inefficient and boards received a number of conflicting messages regarding accounting treatments and the like. A small number of boards complained that their auditors were unavailable to them other than by email, and even then did not return emailed answers. In addition, 17 boards reported that the auditors did not have a sufficient working knowledge of the Rural Lands Protection Act and regulations and 21 boards felt that their auditors had no understanding of the activities, business and functions of the boards. Lack of prior knowledge and planning meant that the amount of time spent on auditing was significantly reduced. One could say that it was new for them, that that could be expected, that they must understand the board system and that that might take time. However, that was a strong view. There was also a view that the auditors spent a lot of time focusing on the form or presentation of the financial statements; that is, whether they were presented in an exact format using points double

underlined, a dash rather than a zero and so on. That was the major focus and many boards believed that the auditors were more interested in form than substance.

Under previous audit arrangements boards would have received their independent audit reports and management letters by 30 April. The majority of boards still have not received them. In the past the auditor would come to a board meeting and sit down with the board and management staff and raise issues that needed to be addressed. That no longer happens. The boards get a mailed set of financial statements and letter of management. That contact between the auditor and the board has decreased, which is to our disadvantage.⁴⁵

- 3.82 When asked about these concerns, a witness from the Audit Office pointed out that they have systems for evaluating the performance of contract auditors and that if problems were caused by a lack of local knowledge this should improve over time:

Mr WHITE: We have a process where we seek feedback after each year on the performance of our contract agents. If you are saying to me that from the transcript there are some indicators that some of the boards are not entirely happy with the contract agent, we will look at that and consider what we can do. When you say they are still reasonably local, I am not trying to say that our contract agents are in exactly the same places where the board may be located but they are within a region of New South Wales, where that it is down south, up north or west. So there is some local knowledge.

I also make further comment and say that if I am an auditor and I am going around and doing five or six of these boards you would be gathering some quite useful knowledge about the dynamics of each one. So although I might not necessarily have been to number five as yet, because I have done four already that will assist me in how I am doing my work. It lets me build up some core understanding.⁴⁶

- 3.83 The Committee trusts that the standard of service will increase over time as auditors become more familiar with the boards' operations.

Lack of priority for small agencies from Audit Office

- 3.84 One aspect of the State Council of Rural Land Protection Boards' concern noted above was that the majority of boards did not receive their independent audit reports in a timely fashion. The State Council reported that only seven boards received statements by the due date of 20 May despite submitting their accounts on time and only four more received theirs by the end of June.⁴⁷
- 3.85 The Wollongong Sportsground Trust's submission stated that the Trust's accounts seemed to be a low priority for the Audit Office and their annual report was often late because of delays in receiving audited statements.⁴⁸
- 3.86 This may indicate that the Audit Office prioritises its workload in order concentrate on the higher risk agencies with more complex transactions. The Committee notes that such practices could be of concern for smaller agencies.

Cost of audit for Cross-border agencies

- 3.87 A further issue is the comparison of fees charged by the NSW Audit Office compared to those charged by other States. The NSW Agriculture submission contains data on

⁴⁵ Mr Steve Orr, transcript of hearing pp 6-7

⁴⁶ Mr Lee White, transcript of hearing p 45

⁴⁷ Mr Steve Orr, transcript of hearing p 7

⁴⁸ Submission No 13, pp 2-3

audit costs for agricultural industry bodies. Some Murray Valley boards are audited by the Victorian Auditor-General at a lower cost than apparently comparable bodies audited by the NSW Audit Office. The relevant figures are:

	Audit cost	Income	Audit/ income
Audited by NSW Auditor-General			
Wine Grapes Marketing Board	\$10,300	\$578,233	1.8%
Riverina Citrus	\$11,600	\$698,726	1.7%
Audited by Victorian Auditor-General			
Murray Valley Wine Grape IDC	\$2,250	\$443,830	0.5%
Murray Valley Citrus Marketing Board	\$5,700	\$1,278,693	0.4%

3.88 When asked about the reasons for this, a witness from the Audit Office explained that it was not simply a matter of comparing the name and role of these organisations:

Mr J. H. TURNER: You said the costs are set on what is required according to the accounting standards and ultimately Parliament's requirements. We have evidence from NSW Agriculture that you audit the Wine Grape Marketing Board. It had an annual income of \$578,233 and your audit costs were \$10,300. The Victoria Auditor-General audits the Murray Valley Wine Grape IDC, which has a similar income of \$443,830. I do not know whether they audit that for presentation to our Parliament, the Victorian Parliament or both. They have charged an audit fee of \$2,250. They are similar entities in terms of name and income but are charged vastly different audit fees. Why is that so?

Mr WHITFIELD: It could be a number of factors. It depends on the systems that the entity is using and whether someone else is preparing the financial statements. The level of support in documentation and papers presented to us reduces the amount of work we have to do. It is difficult to compare two organisations and say because they have X income they should have Y audit fee. Why is not someone with the same income not charged the same audit fee? That could be for a variety of reasons, such as the nature of the transactions entered into, the fact that a particular transaction required more audit in one year and so on. There are inherent dangers in trying to set fee levels as a percentage of turnover.⁴⁹

3.89 The Committee notes that there may be sound reasons for such variations in audit fees for similar organisations.

Relative costs of auditing for small agencies

3.90 The Committee sought information about whether audit costs are higher for small agencies than for larger ones and the number of agencies which could be classified as "small".

3.91 The Committee found it difficult to generalise about the costs of audit services as these varied between agencies and between the same agencies at different times. In order to test the intuitive sense that, for each dollar of assets, it is more expensive to audit smaller agencies, the Committee asked witnesses from Treasury to provide information about the relative costs of auditing for small agencies.

3.92 Treasury examined the cost of auditing ten larger agencies and ten smaller agencies for the 2001/02 financial year and compared these costs to each agency's total assets, expenses and revenues in that period. They concluded that the marginal cost of the audit decreased with increasing size of an agency. On average:

⁴⁹ Mr Tony Whitfield NSW Audit Office, transcript of hearing p 43

- In relation to **total assets**, the cost of audit for the small entities was more than 99 times higher than for the large entities – ie for the ten large agencies, audit fees were \$52.36 for each million dollars audited but \$5,206.08 per million dollars of assets of small agencies;
- In relation to **total expenses**, the average cost of the audit was nearly five times higher than for the large entities – it cost \$249.33 in audit fees for each million dollars of total expenses in large agencies but \$1,237.13 for each million dollars in small agencies; and
- In relation to **total revenues**, the average costs of audit for the small entities was more than 5 times higher than for the large entities – it cost \$242.37 per million dollars in total revenue in large agencies but \$1,219.28 per million dollars in small agencies.⁵⁰

3.93 The Committee notes that this is a relatively small sample of less than 5% of the more than 400 agencies audited by the Audit office. It does however demonstrate the principle of economies of scale for audit fees.

Reasons for higher audit costs

3.94 The Committee sought information for the reasons these costs could be relatively higher for smaller agencies.

3.95 As noted in Chapter Two, auditing in accordance with the standards requires completion of a number of steps regardless of the size of the agency. The Deputy Auditor-General, Tony Whitfield, described how this could lead to higher costs for small agencies:

Mr WHITFIELD: Under the accounting and auditing standards with any audit you are required to issue engagement letters, client service plans, and a requirement to conduct a base level of auditing to comply with the standards irrespective of the size of the entity. You will do a similar amount of work on a smaller entity as you would on a large entity in terms of looking at governance structures, controls and the like. With larger entities they tend to have bigger systems and therefore you do more controls work. With smaller entities you tend to find that there are probably less controls and less segregation of duties because there are a smaller number of people which then require you to do a more substantive type of an audit as opposed to a control-based audit in a larger organisation. Substantive audits in themselves tend to be more costly than a control-based audit because you need to do more detailed testing to get the level of assurance that you require under the standard to enable you to issue an audit opinion.⁵¹

3.96 The level of fees does not only depend on complexity of audit but the qualifications of staff. The Audit Office operates on a cost recovery basis and there are no discounts for small agencies.

Mr McLEAY: Is that the same rate for large and small agencies?

Mr WHITFIELD: We have a set of charge rates spread across different levels of staff. The mix of staff assigned to an audit determines the average rate. One set of charge rates applies to the different levels of staff. We do not have a set of rates for small, medium and large audits. It depends on the time spent on the audit and the staff mix.

...

⁵⁰ Correspondence from Mr Ian Neale, NSW Treasury 29 August 2003

⁵¹ Mr Tony Whitfield, transcript of hearing p 40

Mr WHITE: The remuneration is aligned to experience and both feed into the charge rate.

Mr McLEAY: Is there any cross subsidisation? Are smaller agencies charged proportionately less?

Mr WHITFIELD: As I said, it depends on the time spent on the audit. In some cases we do not recover the full cost on the smaller audits.

Mr WHITE: There have been instances in the past in which costs have been in excess of what we have charged on some of the smaller audits.

Mr J. H. TURNER: Why make the decision to do that?

Mr WHITE: It depends on the circumstances, whether there were difficulties on our side of the fence and our people did not do something correctly the first time around. It depends on the circumstances.⁵²

3.97 A further consideration is that, in some small agencies, internal controls may not be as strong as in larger agencies. This means that the accounts may not be prepared to as high a standard as in an environment with stronger controls. More effort may be required to address problems. This was explained to the Committee by a representative of the Audit Office:

CHAIR: Do you find that small agencies benefit for assistance in complying with requirements through external audit?

Mr WHITE: I think the answer is yes. We generally find with small agencies that the skills, expertise and understanding of the accounting framework and standards and so on are not as strong as in larger organisations. The organisation may need assistance in finalising the financial statements. We need to be careful with our level of independence, but we try to assist in some areas.⁵³

3.98 The Committee notes that the characteristics of very small agencies can contribute to the proportionately higher auditing costs for these agencies.

CONCLUSIONS

3.99 The Committee notes that there is evidence that for some small agencies the cost of preparing financial and annual reports and paying for audits may be burdensome and disproportionate to the risks faced by these agencies.

3.100 The Committee is particularly concerned at the State Council of Rural Lands Protection Boards reports of unexpectedly large increases in the level of compliance costs since the boards were included in the list of statutory bodies scheduled to the *Public Finance and Audit Act 1983*.

⁵² Mr Tony Whitfield and Mr Lee White, transcript of hearing p 41

⁵³ *ibid* p 42

Chapter Four - Options for Addressing Compliance Burden

- 4.1 This Chapter canvasses the options for addressing the problems identified in the previous chapter and indicates the level of support for each approach identified in submissions and the public hearing.
- 4.2 Most of these options are drawn from submissions made in response to the discussion paper which asked particular questions about:
- the risks in terms of reduced accountability associated with reducing reporting and auditing requirements for small agencies;
 - appropriate characteristics for organisations subject to less comprehensive reporting requirements;
 - appropriate information to include in short form reports; and
 - the appropriate frequency for reviewing these arrangements.
- 4.3 These options relate to changes to financial reporting, annual reporting and auditing requirements and to changes to the structure of agencies. They fall into three broad categories:
- those proposing fundamental changes to reporting or auditing requirements;
 - those proposing exemptions from some or all requirements on a case by case basis; and
 - those proposing structural or administrative changes to reduce the impact of potentially high costs on small agencies.

FINANCIAL REPORTING

- 4.4 The Committee considered two main approaches to reducing the compliance burden for financial reporting:
- exempting some of the agencies currently reporting from preparing financial reports; and
 - reducing requirements by replacing them with short form or concise reports.

Small Proprietary Company Test for Exemption

- 4.5 As noted in Chapter Two, there is a possibility in the legislation for agencies to be declared not to be departments or statutory bodies for the purpose of auditing and financial reporting through sections 39(1B) or 45A(1B) of the PFAA.
- 4.6 The Committee considered on what grounds it might be appropriate to apply such an exemption to small agencies. In its discussion paper, the Committee noted the lesser reporting requirements allowed for “small proprietary companies” under the *First Corporate Law Simplification Act 1995*. These are companies which meet two of the three criteria of having 50 or fewer employees, \$5 million in assets, and revenue of \$10 million or less. These small proprietary companies are not required to prepare

annual financial reports and directors' reports unless ASIC or shareholders direct them to do so.¹

- 4.7 The applicability of these criteria to public sector agencies is highly questionable under the current standards and legislative framework because of the presumption in accounting standards that public sector agencies are reporting entities.
- 4.8 By definition, the financial reporting relief for small proprietary companies under the *Corporations Act 2001*, only applies to situations where there are limited "users" of their financial reports. Users of General Purpose Financial Reports are categorised in Statement of Accounting Concept 2 "Objective of General Purpose Financial Reporting" as:
- **Resource providers**, defined as those who may be compensated for the resources that they provide. This includes employees, lenders, creditors, suppliers, societies and professional bodies, parliament, taxpayers, ratepayers, investors and contributors.
 - **Recipients of goods and services**, defined as those who consumer or otherwise benefit from the goods and services provided by the reporting entity. This includes taxpayers and members of professional associations.
 - **Parties performing a review or oversight function** including parliament, governments, regulatory agencies, and employer groups.²
- 4.9 The nature of the definition of "small proprietary companies" means that the financial reporting relief is only available where there are limited users as defined by each of these categories.
- 4.10 The situation is different for small public sector agencies. As small public sector agencies are generally funded by public funds and administer some form of activity on behalf of the public, it could be argued that the entire state are interested in their financial reporting however rarely this interest is expressed. On this issue, CPA Australia stated that it would be inappropriate to apply the small proprietary company thresholds to public sector entities, because the users of small public sector agency financial reports would be different to that of a small proprietary company.³
- 4.11 In the private sector, Australian Securities and Investment Commission (ASIC) Class Order 98/1418 exempts wholly-owned subsidiaries from the requirement to prepare financial reports where their parent entity prepares consolidated financial statements. The basis of this exemption is that information about the controlled entity is included with the report of the parent organisation, although at the consolidated level.⁴
- 4.12 This is different to the public sector situation. In the New South Wales public sector, small public sector agencies that are wholly controlled by other agencies are still required to prepare separate financial reports through the PFAA.⁵
- 4.13 There was some support in submissions for exempting small agencies, particularly controlled entities, from preparing financial reports. For example, the Auditor-General suggested in a submission that it may be appropriate to amend the PFAA to allow the

¹ *Corporations Act 2001* (Commonwealth), Sections 45A(2), 292-294

² Statement of Accounting Concept 2 "Objective of General Purpose Financial Reporting", paragraphs 16 – 19.

³ Ms Carroll, Technical Adviser, CPA Australia, transcript of evidence p 24

⁴ ASIC Class Order 98/1418 *Wholly Owned Entities*

⁵ *Public Finance and Audit Act 1983*, sections 39(1A), and 45A(1A)

Treasurer to exempt wholly owned subsidiaries from the requirement to prepare financial statements.⁶ The NSW Health submission suggested it would be appropriate for small controlled entities meeting the small proprietary company test to be exempt from preparing financial reports, subject to review of the continued suitability of these arrangements. The submission considered the risks of reducing the reporting requirements for agencies within the Health portfolio to be minimal.⁷

- 4.14 The Committee heard more about the benefits of these criteria as the appropriate threshold for reporting from Mr Ken Barker the Chief Financial Officer:

Mr BARKER: Our general view with the descriptors that you have put forward—less than 50 employees, less than \$5 million in assets excluding land and buildings, and less than \$10 million in revenues—is that if revenues are greater than \$10 million or assets are more than \$5 million excluding land and buildings you should probably get an annual audit certificate. If one of those things is over I think that probably means that you have not satisfied those conditions. Once you get over \$5 million in assets excluding land and buildings you will have a fair bit of cash and investments. Therefore, I believe there would always be a higher probability that someone might try to commit some form of fraud.

In terms of revenues, if revenues are over \$10 million as a stand-alone item there is the potential for higher cash flows. In an accounting sense, I believe people will try anything if they think there is an opportunity. That is why we must rely on internal controls. I think Treasury should review those limits every five years so that they can increase. Otherwise—this often happens in this area—you might settle on \$5 million today but in 15 years it will still be \$5 million. There needs to be a formal review process.⁸

- 4.15 NSW Treasury also made the following comments when discussed amending the PFAA to enable differential reporting:

Mr NEALE:...One of the reasons that our Act is so all-encompassing is that the Auditor-General has raised concerns over time about some subsidiaries escaping the audit net. Because of that we have had to amend the Act on a number of occasions to try to capture those sorts of entities. For that particular reason we are reluctant to move away from that approach.⁹

- 4.16 Comments by NSW Treasury on the risks of differential reporting are included below. These risks would apply even more to the situation of exempting agencies from reporting. While it could be argued that the risks would be partially offset through the reporting and auditing of controlled entities at the consolidated entity level, the Committee considers that there would still be unacceptable levels of risk from this approach as the detailed disclosures in a financial report prepared at the subsidiary level would not be carried over to a financial report prepared at the consolidated level. In addition, the audit of a consolidated entity would be to the consolidated entity's materiality rather than the subsidiary's materiality. The overall result would be a loss of accountability, and increased risk.
- 4.17 On the basis of the evidence presented to it, the Committee does not support exempting standalone agencies that are reporting entities from reporting on the basis of size or a perception of lack of risk. This is because the Committee considers it

⁶ Submission No 7 p 3

⁷ Submission No 12, pp 2-3

⁸ Mr Ken Barker, NSW Health, transcript of hearing p 17

⁹ Mr Ian Neale, NSW Treasury transcript of hearing p 33

appropriate for Parliament to have some supervision of the management of public money.

- 4.18 If an exemption scheme did exist, there would be a number of difficulties to overcome. Mr Martin Smith from Treasury described the difficulties of administering an exemption scheme to the Committee:

Mr SMITH: Before I turn to that question, I must point out that there is a presumption in the accounting standards that if an entity is important enough to have a separate existence it is important enough to perform separate accounting. As to thresholds, there are several issues. One is who will determine those thresholds in the ongoing sense. For example, if we have a threshold of \$5 million—that is the first number I thought of—what will it be for? Will it be for total expenses, total assets or net assets? What will happen when that changes? Ian has referred already to the contingent liabilities and to non-financial items. Will Treasury or the Auditor-General determine that and when will they determine it? I imagine there could be an issue during the planning stage of financial statements when an agency's financial information may be below the threshold but we find through audit that it is more than the threshold.

How does that affect our reporting? If we decide that it is below the threshold, is it two years before we discover that? A great many risks are involved. Mr Barker, who gave evidence earlier, referred to the small proprietary companies test, which I think involved 50 employees and certain turnover levels. So it is possible. It has been done in the private sector. However, whether or not it is desirable is a different matter. I can see some serious implementation problems. It is possible that Parliament would not be getting information from these entities on a timely basis.¹⁰

- 4.19 Previous NSW Public Accounts Committees have also been active in strengthening reporting requirements and commented on the need for effective supervision of subsidiaries. In 1990, the then Committee recommended that the Auditor-General be notified when agencies established subsidiaries in order to ensure that these were audited.¹¹
- 4.20 The Committee considers that controlled entities that meet the definition of a “reporting entity” should continue to prepare financial reports.
- 4.21 However in its submission, the Auditor-General noted that not all of the controlled entities included in the “invited audit” list prescribed in the regulation to the PFAA were necessarily reporting entities.¹² As noted in Chapter Two, the Auditor-General conducts these audits in accordance with a request to audit an entity under section 45 of the *Public Finance and Audit Act 1983*. When asked about this at the hearing, the Deputy Auditor-General clarified this point:

CHAIR: The Auditor-General's submission to the Committee, under the heading "Options" and the heading "Particular Audits" states that "there are a further 45 statutory bodies prescribed for the purposes of division four in part three of the Public Finance and Audit Act. These bodies are prescribed because the Auditor-General's mandate is not established elsewhere in the Act. While it is appropriate for the Auditor-General to audit these entities, it may not be essential that the smaller bodies prepare general purpose financial reports." My question in regard to that submission is this: Is this because of their size or because it would not be a requirement under the Australian accounting standards?

¹⁰ Mr Martin Smith transcript of hearing p 35

¹¹ PAC report No 49 *Report on the NSW Auditor-General's Office*, 1990, pp 2-43

¹² Submission No 7, p 3

Mr WHITFIELD: It may be because there is no public interest in those particular bodies. They may have been set up for a purpose that is only reporting to another body and that information, if it gets picked up in that body, does not need to be in a general purpose format.

Mr McLEAY: Can you explain that again?

Mr WHITFIELD: What I am saying is that it may be a body that is set up. One that comes to mind is a superannuation trustee for a superannuation fund of a university. It is not a controlled entity of the university but there is a need to have it audited, but it just reports to the university to say that the superannuation fund is being correctly maintained. The public is not necessarily interested in that, but the university is.¹³

4.22 The Committee concludes that, if this is the case, reporting and auditing could be an unnecessary expense for some agencies included in the invited audit list. The Committee notes that in circumstances where bodies on the invited audits list are not controlling public money, the need for continuing to maintain the audit arrangements should be reviewed periodically by the person who made the request for the audit. If the audit is no longer required, the agency should be removed from the list of invited audits.

RECOMMENDATION 1: The Treasurer or responsible Minister should periodically review the continued need for the Auditor-General to audit each entity not administering public funds on the “invited audit” list (those prescribed in the regulation for the purposes of section 45 of the *Public Finance and Audit Act 1983*). If the audit is no longer deemed necessary, then the entity should be removed from the list.

4.23 While the Committee does not support reporting exemptions on the basis of the evidence presented, there may be circumstances where there are strong internal controls such as for entities within the Health portfolio, where a less stringent standard of reporting would be suitable. This is discussed further below.

Simplified reports

4.24 The Committee also considered ways of reducing the compliance burden for small agencies, by examining alternative reporting models to general purpose financial reports. These included short form or concise financial reports prepared under AASB 1039 and other types of special purpose financial report.

4.25 As noted in Chapter Two, the Treasurer has the authority in consultation with the Auditor-General to provide exemption from particular financial reporting requirements in individual agencies where these are burdensome or misleading. However the granting of relief under these sections is likely to result in a qualified audit report being issued by the Audit Office and would also mean less disclosure and, therefore, a lower level of accountability.

4.26 In its evidence the Committee, NSW Treasury emphasised the presumption in the accounting standards that if a small public sector agency is important enough to have been given a separate existence, then it is also important enough to perform separate accounting. Consistent with this presumption, all exemptions from Australian Accounting Standard reporting requirements were withdrawn from March 2001. Since this date, all agencies have been required to comply completely with the

¹³ Mr Tony Whitfield, transcript of hearing, p 47

accounting and legislative framework. Furthermore, the Treasurer advised the Committee that he considered it appropriate for Parliament (rather than the Treasurer) to sanction any reduction in reporting standards.¹⁴

- 4.27 There was some support in submissions for simplifying reporting requirements where these are a burden. In a submission from the Queensland Audit Office, the Committee was told that, in Queensland, some small agencies report on a cash basis and prepare special purpose financial reports instead of general purpose financial statements.¹⁵ However, given that NSW public sector entities are regarded as reporting entities required to comply with Australian Accounting and Auditing Standards, this approach is not available in the NSW public sector.
- 4.28 Mr Ken Barker, the Chief Financial Officer for NSW Health, suggested that controlled entities could prepare short form financial statements if they met the criteria of the small proprietary company test and information could be published on the internet rather than in printed reports. He suggested that this approach would make information more accessible than in the past.¹⁶ He stated that:

Mr BARKER: As I said, we are slightly different because NSW Health is a \$9.3 billion organisation reported in this process and in the State budget process within which there is a whole range of checks and balances to get to that conclusion. In terms of our position with our smaller agencies which, for the purposes of the inquiry of the Committee, are very small we still have to go through—not as detailed rigour as this—a process. Most probably five years ago, if you were a shareholder of a company you got an annual audited set of financial statements and a report. Now the trend is to either get it on the web site or maybe you get a couple of abridged A4 pages, if you are lucky, in terms of how your organisation is travelling.

Government needs to think whether it has got some capacity within some parts of government to take some of those leads in this area. We are all being required within government to be a little bit more careful in how we do certain things in terms of use of resources and we have got virtually three sets of resources to do that: we have to pay an external provider to print it; we have got to pay the Auditor-General to audit it; and then we have to engage our in-house staff to actually produce it. I still have to go through a process of reviewing what is involved in them in terms of their promulgation. We still get involved in discussions with the Audit Office about them and yet at one end of the scale they are very small compared to what the other part of the \$9.3 billion organisation is doing.¹⁷

- 4.29 He considered that strong internal controls were essential, as well as a review by the Auditor-General of the suitability of the concession for that agency at periods of around five years.¹⁸
- 4.30 Mr Whitfield, the Deputy Auditor-General, also noted the consequences of completing full financial statements for some small agencies and suggested developing simpler arrangements if these were appropriate:

Mr WHITFIELD: Unfortunately, if you are a reporting entity, which the majority of public sector agencies are, you get saddled with all the accounting standard requirements and you could have copious pages of notes. Whether you are a big or a small agency the size

¹⁴ Correspondence from the Treasurer 2 October 2003

¹⁵ Submission No 5 p3

¹⁶ Mr Ken Barker transcript of hearing p 17

¹⁷ *ibid* pp 21-22

¹⁸ *ibid* p 19

of your annual report can vary minutely simply because of the disclosure requirements. You may have a turnover of only half a million dollars but you would still end up with a 30-page annual report with financial statements in it because of the disclosure requirements under the standards. Treasury needs to look at a modified or condensed version of the reporting requirements, if it believes it does not need all the detail to be included in the financial statements of the smaller agencies.¹⁹

4.31 This suggests that, under the current accounting and legislative framework, small public sector agencies are very likely to be reporting entities and required to prepare GPFs. For a reduced form of financial reporting to be introduced for small NSW public sector entities, a new framework is required. It is the responsibility of the Treasurer and NSW Treasury to develop an alternative framework.

4.32 Witnesses from CPA Australia were strongly opposed to differential reporting for public sector entities as it would be inconsistent with the national accounting framework. The CPA submission also commented that:

Whilst CPA Australia does not support differential reporting in this context within the current framework, if differential reporting were to be implemented, accounting standards would need to be changed to allow comprehensive financial reporting as currently there is no accounting standard which allows “less comprehensive” reports in any sense other than by applying materiality considerations. Concise Financial Reports under Australian Accounting Standards, AASB 1039: Concise Financial Reports, apply only to entities listed in the Corporations Act 2001 (Cwlth) and are in addition to full financial statements. That is, they serve not to lessen the cost of scrutiny but simply to limit the information for readers.²⁰

4.33 The Committee discussed who determines the level of financial reporting appropriate for NSW public sector agencies with Ms Cath Mulcare, from CPA Australia:

Mr J. H. TURNER: As I said at the outset, who is the doyen of what is transparent? Who sets the benchmark of transparency? Does the CPA do it? Does the Auditor-General do it? We are talking here about some organisations that have fewer assets and less income than the tennis club in my home town. Who sets this transparency that you have referred to fairly constantly through your submission today?

Ms MULCARE: I think the transparency comes from providing enough top level information. I know that earlier you referred to concise financial reports as an example under AASB 1039 but it still requires the drill down to a level where somebody can get the answers they require. Whether or not that is available to everybody en masse, in which case they will not read it anyway, or it is provided on demand, which was another suggestion, it is still that ability for the users and ultimately within the public sector that is the parliamentarians representing the voters to say, "This is the level of detail I require and this is the fundamental accountability."²¹

4.34 This indicates that it is the accounting framework that interprets the level of “transparency” that is required of public sector entities. The accounting framework assumes that parliamentarians representing the public need access to all of the information required to be disclosed in GPFs. The only situation where entities are permitted to prepare AASB 1039 concise financial reports under the current system is if they have already produced full GPFs. Therefore, under the current framework, accountability requires Parliament to have access to full GPFs rather than AASB

¹⁹ Mr Tony Whitfield, transcript of hearing p 49

²⁰ Submission 10 CPA Australia, p 10

²¹ Ms Cath Mulcare, CPA Australia, transcript of hearing pp 25-26

1039 concise financial reports. This is consistent with the evidence received by the Committee that there is very little flexibility under the current accounting framework.

4.35 In its submission, NSW Treasury also opposed introducing differential reporting for small agencies on the grounds that agencies established by Parliament should be subject to reporting requirements. Particular risks associated with establishing a differential reporting scheme include:

- Differences of opinion as to the status of an agency;
- Changing status of agencies between reporting periods;
- Selection of information to be included in condensed reports could lead to perceptions in large agencies that the government did not consider other information as important; and
- Incentives could be created for agencies to structure transactions through small controlled entities as a method of avoiding public scrutiny.²²

4.36 Mr Neale of NSW Treasury explained these concerns about the risks in greater detail:

Mr TORBAY: What are the risks with differential reporting?

Mr NEALE: It is a question of how you set the criteria under which agencies would be classified as those that needed to report fully and those that needed to report in some sort of differential way. It becomes very subjective assessing whether agencies meet criteria from time to time. A good example of that is that the Public Finance and Audit Act says that the auditor has to give a view as to whether accounts are true and fair. Auditors and other people in the organisation can all have different views about what is true and fair. So it becomes something of a misnomer, if you like. If you set criteria for individual agencies against which you would measure agencies at a particular point in time those criteria might suit an agency but it could change very rapidly. Treasury is particularly concerned about potential contingent liabilities that may be entered into by an agency—knowingly or unknowingly. If you do not have a sort of rigorous reporting in place that can go undetected until it becomes a crisis. We have had examples of quite small agencies entering into very large commitments. There are a lot of trusts around that have the capacity to do that. They have the legislative capacity to do it as well. So they can enter into some commitments which at the end of the day can get them into financial problems. Invariably it comes back to Treasury to try to bail them out.²³

4.37 The Treasury submission also noted that responses to the 1998 working paper *Fundamental Review of NSW Financial and Annual Reporting Legislation* did not support introducing differential reporting for small agencies and the working party managing the review did not pursue it further as an option.²⁴

4.38 The Committee notes that differential reporting is not available to small public sector reporting entities under the current accounting and legislative framework. Within the constraints of the current arrangements the only flexibility is for the Treasurer to offer exemptions to agencies facing difficulties in meeting reporting requirements, knowing that it is likely to result in a qualified audit opinion. However, as noted above, the Treasurer has advised the Committee that he preferred not to use his existing powers to exempt agencies from particular reporting requirements without the sanction of Parliament.

²² Submission No 4 NSW Treasury Appendix 1

²³ Mr Ian Neale, transcript of hearing p 32

²⁴ Submission No 4. Appendix 2

4.39 The Committee generally concurs with the Treasurer's position on this issue. However there may be specific circumstances where a specific exemption is justified. This is discussed further below.

4.40 The Treasurer also advised the Committee that he would not support the introduction of differential reporting for small agencies ahead of the preparation of advice on the treatment of small and medium sized entities (SME) by the International Accounting Standards Board (IASB). This guidance is scheduled to be released in draft form by June 2004 and a final version released no later than December 2004.²⁵

4.41 As described in Chapter Two, the IASB develops standards for adoption by national bodies. Decisions about the applicability of standards to particular types of entity are matters for each country's governments. At a meeting in July 2003 the IASB voted unanimously to determine the intention of this project to be:

To reduce the burden of disclosure and to preserve the recognition and measurement principles of the [International Financial Reporting Standards] unless, with Board approval, a case can be made on cost-benefit grounds for some simplifications of IFRS standards applicable to SMEs.²⁶

4.42 At subsequent meetings, the IASB resolved that the basis for modification to the standards and guidance framework must be based on the identified needs of users of SME financial statements. The Board felt that it was likely that some disclosure and presentation modifications will be justified based on user needs, but there would be a rebuttable presumption that no modification would be made to the recognition and measurement principles the standards.²⁷

4.43 The Board also resolved that it should agree on the types of entities for which it believed any modified SME standards would be appropriate but that it should avoid adopting quantified size criteria.

4.44 However it is unclear how applicable this approach would be for public sector entities in New South Wales. Early decisions in relation to the project are geared to addressing the reporting requirements of unlisted companies not dependent on capital markets for expansion. At a meeting in December 2003, the Board decided that it was appropriate to develop alternative standards to the IFRS for entities which have "no public accountability". This principle implies that an entity is publicly accountable if:

- There is a high degree of outside interest in the entity, from investors or other stakeholders;
- The entity may have a social responsibility because of the nature of its operations; and
- The substantial majority of stakeholders depend on external financial reporting, as they have no other way of obtaining financial information about the entity.²⁸

²⁵ Correspondence from the Hon M R Egan MLC, Treasurer, to Mr Matt Brown MP, Chairman, 2 October 2003

²⁶ *IASB Accounting Standards for Small and Medium Sized Entities: topic Summary*, revised 30 October 2003, downloaded from www.iasb.org.uk, p 2

²⁷ *ibid* p3

²⁸ IASB, *Board Decision on International Financial Reporting Standards*, December 2003, downloaded from www.iasb.org.uk, p 10

- 4.45 The Board also agreed to some criteria for assessing whether organisations had public accountability. This included that “it is a public utility or similar entity that provides an essential public service”. The Board then asked staff to consider adopting a different name for the standards based on the concept of lack of public accountability.²⁹
- 4.46 On the basis that current Australian accounting standards contain a default position that public sector agencies are reporting entities, the Committee considers it unlikely that the amended standards developed by this international project will be adopted by the AASB in such a way as to apply to NSW public sector agencies. However the Committee notes that this project is at an early stage of development and these resolutions may change in light of subsequent debate.
- 4.47 The Committee considers it prudent to await the outcome of this project and the consideration of its adoption by the Australian Accounting Standards Board given Australia’s commitment to harmonisation with the international standards (IAS) in 2005.

RECOMMENDATION 2: The Treasurer should review the continued appropriateness of reporting arrangements in light of advice issued by the Australian and International standard setting bodies about the treatment of small and medium enterprises if this advice applies to public sector agencies and recommend appropriate changes to Parliament.

- 4.48 As noted in Chapter Two, the Treasurer has the authority under the PFAA, after consulting the Auditor-General, to exempt agencies from a financial reporting requirement that is considered to impose an “unreasonable burden”. Any such exemption is likely to result in a qualified audit opinion being expressed on the agency’s financial report. The Committee has received evidence that no such exemption has been issued (or exists) since March 2001.
- 4.49 Treasury has indicated that they would be unlikely to give such exemptions in the future on the basis that, if Parliament decides that an entity needs a separate legal existence, Parliament also requires the agency to prepare separate financial reports. A financial reporting exemption would result in the agency not disclosing the information that the accounting standards presumes that Parliament requires. Furthermore, the Treasurer advised the Committee that he considered it appropriate for Parliament (rather than the Treasurer) to sanction any reduction in reporting standards.³⁰
- 4.50 While the Committee generally agrees with the view of Treasury, it recognises that there may be exceptional circumstances where such an exemption may be justified. For example, the cost of obtaining some financial information may be so great for an agency that it outweighs the cost of providing an exemption. The benefit of any such an exemption would be a lessening of the financial reporting burden experienced by agencies, while the cost would probably be a qualified audit opinion, and, arguably a loss of accountability.
- 4.51 Given that Parliament has provided the Treasurer with this authority, the Committee considers that agencies should be able to seek an exemption from requirements where

²⁹ *ibid* p 11

³⁰ Correspondence from the Hon M R Egan MLC, Treasurer, 2 October 2003

they impose an “unreasonable burden”. It is up to the Treasurer to make the judgement on whether such an exemption should be given. Logically exemptions would only be granted, if the benefit of doing so were greater than the cost.

RECOMMENDATION 3: In exceptional cases where a financial reporting requirement is imposing an “unreasonable burden” on agencies, agencies should approach the Treasurer for an exemption from that requirement.

Simplifying requirements for Annual Reports

- 4.52 As described in Chapter Three, few submissions identified the cost of preparing annual reports as burdensome. However the Committee was provided with some suggestions for improving the current arrangements.
- 4.53 As noted above, Mr Barker, the Chief Financial Officer of NSW Health, suggested that annual reporting could be streamlined by presenting short form annual reports instead of full annual reports on the model of private companies to shareholders.
- 4.54 The Queensland Audit Office submission noted that Queensland has introduced summary or short form annual reports for small agencies. It has advantages of lowering costs and maintaining accountability:
- The creation of streamlined financial reporting processes and use of short form or summary reports could reduce the dollar cost of accountability measures, while still retaining independent scrutiny and assurance over public sector entity operations.³¹
- 4.55 However the submission also noted that one drawback with this approach is that small entities may not report information in a consistent way.
- 4.56 The Treasury witnesses discussed the ways in which annual reports could be simplified for instance by removing the requirements to report on EEO performance, water use or compliance with credit card guidelines:

Mr NEALE: Basically, the Treasury has reservations about differential reporting for smaller agencies. But that is not to say that there could not be some efficiencies brought into play in the way in which they do report. In our submission we made the point that we felt that there was a way to take away some of the compliance reporting from annual reports, and that could affect all agencies across the public sector. Probably a lot of that compliance reporting could be dealt with better by some sort of central database whereby agencies input data electronically. That could be stored by a central agency such as Treasury or the Premier's Department and it could be available on the Web and a separate reporting volume could be published each year if it were felt appropriate. That mechanism would reduce a lot of the effort and detailed reporting that agencies have to do at the moment. Therefore the reports would become more focused on the actual performance of that agency in terms of delivering its core services. That is pretty much a summary of our submission in a very small nutshell.

CHAIR: Would that require a legislative change?

Mr NEALE: It would, Yes. At the moment the regulations to the annual reporting legislation specify a whole lot of requirements that agencies have to report against. For instance, there is a reporting on the number of credit cards, usage, whether accounts were paid on time, and things like FOI applications received and the like. A lot of that information could be reported centrally.

³¹ Submission No 5, Office of the Auditor-General of Queensland, p 2

Mr WHAN: Could you elaborate on any other areas that could be included in that database approach?

Mr NEALE: There are a lot of requirements dealing with equal opportunity of employment in the public sector. I think there is a requirement about water usage. I am not sure whether electricity usage comes into it too. There are things that have been at the top of people's minds at a particular point in time and agencies have been required to report against them. This is encapsulated in the regulation and it just adds to a growing list of items that agencies have to report against. I am not aware of many of those items being taken off.³²

- 4.57 The Committee notes that some of these issues appear less crucial to public understanding of an agency's performance than others. However the decision to include these compliance reporting requirements would have been a policy decision made by a Minister and agreed by Parliament. The Committee is not empowered to query the individual policy decisions involved and considers that that it would be more appropriate for the Government to review the continued appropriateness of these requirements.
- 4.58 In October 2003 the Treasurer advised that Treasury intended to review these requirements and consider whether some of them could be removed and instead collected and placed in a database. This would contribute to lower costs for annual report preparation.³³
- 4.59 The Committee supports this review if it assists in reducing the cost of reporting requirements for small agencies without reducing accountability.

REDUCED BURDEN FOR AUDITING

- 4.60 The Committee sought information on options for reducing the cost of auditing for small agencies. Options included exemption from external auditing, less frequent auditing and reducing the scale of audit where appropriate.

Exemption from auditing

- 4.61 The NSW Health submission suggested that there would be benefits if some small agencies within the portfolio could prepare financial reports in accordance with the accounting standards but only be subject to external audit if they exceeded two of the three criteria in the small proprietary company test.³⁴ This would mean that such an exemption would be limited to small agencies with low levels of assets and income and few employees.
- 4.62 The submission stated that this would have the advantage of saving the cost of the audit fee as well as the time taken to respond to audit enquiries which could take far longer than preparing the accounts.³⁵
- 4.63 This approach would separate the need for preparing financial reports from the need for external audit. The submission also proposed that:

Where, in retrospect it was found that expenses, revenues or assets (others than through asset revaluations) varied by more than 10% from the previous year an audit of the

³² Mr Ian Neale, transcript of hearing pp 31-32

³³ Correspondence from the Hon M R Egan MLC, Treasurer, 2 October 2003

³⁴ Submission No 12, NSW Health, p 2

³⁵ *ibid* p 4

ensuing year's accounts could be required inclusive of verification to the previous year's comparatives.³⁶

- 4.64 In the case of the health portfolio bodies, such as the professional registration boards, variations in the order of 10% could arise due to variations in the number of registered health professionals leading to variations in fee levels.
- 4.65 Such an exemption scheme could have an element of external scrutiny: in order to ensure continued accountability, an external agency such as Treasury or the Audit Office should be responsible for monitoring agencies' continued compliance with the criteria. The cost to the external agency of administering the scheme would to an extent offset the savings achieved by removing the audit fee.
- 4.66 A difficulty is the retrospective nature of the scrutiny: as the proposal does not include auditing of the accounts in the year in which the any variation in assets, expenditure or income occurs, there could be considerable time between, for example, the incurring of losses or corrupt activity and its detection.
- 4.67 In cases of controlled entities subject to strong internal controls, such an approach may be acceptable. As noted in the submission from the NSW Auditor-General, if relief from separate financial reporting requirements was provided to wholly owned entities, then the audit would only be to the consolidated entity's materiality. This would significantly reduce the audit effort directed at the controlled entity.³⁷
- 4.68 However this approach was not supported by CPA Australia on the grounds that it was an unacceptable risk for public sector agencies. Ms Cath Mulcare told the Committee that:

...There would be no stepping back from the transparency and accountability issue and the differences between the private sector and public sector in terms of the users. I would expect that there is some acceptance of the fact that the scrutiny that parliamentarians would be under if \$100,000 was lost through any of those agencies where somebody had accepted that additional level of audit was not required. The discussion of materiality is an interesting one because it is not material to the organisation. A comparison of any agency in its own right to the Federal budget, for example, or to the State budget would make all of them immaterial but the fact is that the materiality is not to the organisation. The materiality is to the users and them making their decisions. It is that part that I think we lose sight. I would argue that to some voters, regardless of the size of the whole organisation, \$1 million would be material to most in their decision regardless of the net assets of that organisation and how many billion dollars we are talking about in public sector funds. So that would be my other concern. No matter how much you break down the small agency the risk is that you will lose something in that accountability that in the public sector is just that much more important even than in the smaller end of town of the private sector.³⁸

- 4.69 The submission from the Queensland Auditor-General noted that in Queensland the Auditor-General's powers had been increased in 2001 to audit controlled entities as well. The submission noted:

In small organisation where there are often weak internal controls, external audit and reporting deter opportunities for fraud, misappropriation or corruption, and act to detect

³⁶ *ibid* p 2

³⁷ Submission No 7, Auditor-General, p 3

³⁸ Ms Cath Mulcare, transcript of hearing p 25

going concern issues, all of which attract considerable attention from a public interest point of view. In this respect, materiality levels are not relevant.³⁹

- 4.70 In addition, without auditing, the Parliament could have no reliance on the veracity of accounts and there would be risks of assessing the continued suitability of a small agency for exemption from audit. It could also be argued that there could be an incentive for the unscrupulous to structure transactions through controlled entities to avoid public scrutiny.
- 4.71 Auditing of financial accounts is a requirement for all agencies covered by the PFAA. In light of comments about the importance of accounting for public funds and uncertainty about the level of the compliance burden for small agencies, the Committee does not consider it appropriate to recommend exempting small agencies from auditing requirements at this stage.
- 4.72 This position should be revisited after the finalisation of the IASB project on reporting requirements for small and medium sized entities.

Less frequent auditing for small agencies

- 4.73 In its discussion paper, the Committee asked for views on whether it would be appropriate for small agencies to be audited less frequently than every year. In the case of controlled entities, one option could be to require that they only be audited as part of the consolidated entity's financial report, and not as separate entities. Under this model, in most years, the auditor would only need to ascertain enough information about the small agency to ensure the statements of the consolidated entity were materially correct. In some years, perhaps every third year, the small agency could be audited in more detail.
- 4.74 There was some support for this approach. The submission from the Wollongong Sportsground Trust considered that it would be appropriate for the Trust to prepare regular financial reports and for these and the Trust's internal control processes to be audited externally every three years.
- 4.75 A representative of the then Department of Agriculture told the Committee he considered that less frequent audits would provide adequate scrutiny of the accounts of the Agricultural Scientific Collections Trust as very few transactions went through the Trust's accounts and it was under the control of the Department. The purpose of the Trust was to protect the collections.⁴⁰
- 4.76 The Audit Office considered that this approach would not significantly reduce the level of audit effort required and would lead to a qualification of an agency's accounts under the current framework. Mr Tony Whitfield, the Deputy Auditor-General, and Mr Lee White, the Assistant Auditor-General described the difficulties of this option to the Committee:

Mr WHITFIELD: If you did the full three years in one there may be a slight saving in the audit cost because you would still be required to have presented to you financial statements for each year so that you could audit the transactions. So you would be doing three years work in one hit which may save you some cost. If you went to not auditing two years and auditing one year we would have a problem in that to determine the opening balance in any year you need to look at the earlier three years anyway and do a

³⁹ Submission 5, Office of the Auditor-General of Queensland, p 2

⁴⁰ Mr Heffernan, NSW Agriculture, transcript of hearing p 12

certain amount of audit work, otherwise you would end up having to issue qualifications. Entities tend to view qualifications as not a nice thing to have and it tends, irrespective of the qualification, to give the perception that there is something wrong, otherwise why be qualifying. You are only qualifying because of a technical issue that you have not audited the prior two years so that would cause some difficulty.

Mr WHITE: In the example where you were saying that you might audit them all for three years in one hit, you then have a risk—I am not saying it is a great risk but you have a risk—that something might have happened early in year one and then it has been perpetuated for the next two years and only come to light at the end of the audit process. So in that situation someone might well be saying, "Why did the audit only occur at that time?"⁴¹

- 4.77 This option would create unacceptable risk to public accountability and is unlikely to lead to much reduction in the audit effort. The Committee does not consider legislative change to allow such an exemption warranted.

Changing scope of audit

- 4.78 As noted in Chapter Two, the Auditor-General has very little flexibility in practical terms on how audits are undertaken.

- 4.79 The Committee has been advised that, in Queensland, the Audit Office sometimes undertakes less intensive audits than in other years for some very small low risk rural and regional agencies. This is not an exemption from annual auditing requirements. Rather, the Office undertakes a preliminary assessment on the basis of an agency's accounts and makes a risk management decision whether a site visit is essential as well as the desk audit. If it is decided that a site visit is not required, the Auditor General signs an audit opinion in the same terms as for other audits.⁴²

- 4.80 The Treasurer has advised the Committee that in the past the NSW Audit Office undertook similar auditing practices, particularly in the case of agricultural marketing boards. There are not legislative barriers to this approach: it is rather a matter of professional judgment of auditing.⁴³

- 4.81 The Committee considers that, where appropriate, the Auditor-General should consider cost-effective practices in these terms and only apply the appropriate level of audit effort where agencies are small and low risk. Agency staff should be able to discuss the level of audit effort appropriate for the agency with the Audit Office staff in negotiating the audit.

RECOMMENDATION 4: In discussing planned audits, the Audit Office should provide information to agencies so that cost-effective auditing practices are used and the appropriate level of audit effort is applied where agencies are small and low risk.

⁴¹ Mr Tony Whitfield, Mr Lee White, transcript of hearing, p 47

⁴² Meeting between Public Accounts Committee and Qld Auditor-General 18 August 2003, conversation with Mr John Findlay Director of Audit Policy 3 September 2003

⁴³ Correspondence from the Hon M R Egan MLC, Treasurer, 2 October 2003, Appendix p 1

Reducing auditing costs to agencies

- 4.82 As noted in Chapter Three, the level of audit fees was of concern to some agencies, particularly where there was unexpected increases in the level of fees as experienced by the Health portfolio and the Rural Lands Protection Boards.
- 4.83 The Committee notes that the Audit Office is not in the business of making a profit. However as the Audit Office has a monopoly in the provision of auditing services, agencies are not able to seek lower fees from other suppliers. In cases where contract auditors are used rather than Audit Office staff, these arrangements are made by the Audit Office on behalf of agencies. The Committee understands, however, that where contract auditors are engaged, it is the result of a competitive tender process.
- 4.84 The Committee was advised by the Audit Office that small agency audit fees were of concern in other jurisdictions. Mr Tony Whitfield, the Deputy Auditor-General, told the Committee:
- The New Zealand Audit Office gets a subsidy from the government to offset the cost of the small audits. This issue arises with every Auditor-General in virtually every country, because of the accounting standard requirements there appears to be a burden, for want of a better word, on smaller agencies because of the cost of carrying out an audit. The New Zealand Audit Office gets a subsidy, so it can charge a lower fee to the audit agencies. That subsidy comes out of the New Zealand Treasury; that is an alternative.⁴⁴
- 4.85 In Western Australia, the level of audit fees for small agencies is not of major concern to the state. Mr Des Pearson, the WA Auditor General, told the Committee that this was because audit fees for budget-dependent agencies are provided centrally.⁴⁵
- 4.86 The Committee considered that central provision of audit fees would reduce concern amongst smaller agencies about the level of fees. This approach would also increase the level of independence of auditors as there would be no need for agencies to debate the amount of time and money required to undertake an effective audit.
- 4.87 However, without monitoring of audit fees by each agency, this approach could lead to an overall increase in the cost of financial audits. Some benchmarking of auditing costs would be required.
- 4.88 There is another risk that the Audit Office would not receive adequate funding from the Budget to undertake effective audits of all agencies. This could lead to a lessening of accountability to Parliament.
- 4.89 The Committee also considers it may not be appropriate for non-budget dependent agencies to receive a subsidy from the Treasury for the cost of auditing as these agencies have other sources of income.
- 4.90 In the past, the Committee has supported the commercialisation of the Audit Office and the recovery of the cost of audits from agencies. The reasoning behind this support was that it makes agencies conscious of the level of service received and provides an incentive for agencies to develop stronger internal accounting processes in order to minimise the costs of audits.⁴⁶

⁴⁴ Mr Tony Whitfield, transcript of hearing p 49

⁴⁵ Meeting with Public Accounts Committee 3 February 2004

⁴⁶ PAC report 49, *Report on the NSW Auditor-General's Office*, 1990, p 94

- 4.91 For these reasons, the Committee considers the costs of returning to central funding of auditing would be likely to outweigh the benefits of reduced compliance costs for small agencies.
- 4.92 However, there is a chance that the level of fees may drop in the future. A recent independent review of the Audit Office conducted by Acumen Alliance pointed out that the Office's financial audit fees also include the costs of compliance audits and half of the funding for the performance audit program. The total fees raised in 2001-02 through audit fees was \$21.2 million. Of this amount approximately \$1.3 million, or some 6 per cent, was attributed to the cost of performance audits.⁴⁷
- 4.93 Performance audit subjects are selected for their scale and significance to the state as a whole. Recent topics have included the disposal of Sydney Harbour Foreshore land, the performance of hospital emergency departments and the incidence of non-licensed driving. It is extremely unlikely that very small agencies would be chosen as subjects of these audits and are therefore contributing to an Audit Office function from which they are unlikely to benefit.
- 4.94 The independent review recommended that the Audit Office approach the Treasurer and seek funding for the entire cost of the performance audit program from the Budget as well as for the compliance audit program.⁴⁸
- 4.95 In subsequent discussions with the Auditor General, the Committee learnt that the Auditor-General planned to seek funding for the performance audit function from Treasury but considered it inappropriate to seek separate funding for the compliance audit function.⁴⁹ If this approach is successful, small agencies could pay lower audit fees in future.
- 4.96 The Committee also considers that there should be a regular process of dialogue about the level of audit fees where they are of concern to agencies. If they have varied in the order of 25 per cent per year and this cannot be attributed to significant changes in an agency's structure, type of business or risk profile, there should be a central review mechanism of the level of audit fees. Senior Managers of agencies should monitor this variation in the first instance, and if required, discuss it with NSW Treasury.

RECOMMENDATION 5: Senior Managers of agencies should monitor the auditing costs for small agencies under their control. Where there is a greater than 25% change between years, a review of the reasons for this change should occur and be discussed with NSW Treasury and the Audit Office.

STRUCTURAL CHANGES

- 4.97 As noted in Chapter Three, some agencies are small by design, while others become that way because of operational changes. The Committee has considered options for reviewing the processes that could lead to unnecessarily burdensome compliance.

⁴⁷ Public Accounts Committee, *Review of the Audit Office under Section 48A, Public Finance and Audit Act 1983*, November 2003, p 185

⁴⁸ *ibid* p 191

⁴⁹ Meeting of the Public Accounts Committee 1/2004, 16 February 2004

4.98 A number of submissions pointed out that an alternative approach to addressing the compliance burden of reporting and auditing requirements for small agencies would be amalgamating small inefficient agencies where this is appropriate.⁵⁰ For instance the NSW Treasury submission commented:

Concerns regarding the number of requirements imposed on small agencies may also be managed by considering, from time to time, the continued appropriateness of structural arrangements for service delivery. This includes assessing the most efficient and effective structures for delivering services, taking into account any changes in function, economic environment and interrelationships with other agencies.⁵¹

4.99 In the hearing, a witness from the Audit Office suggested that consideration be given to amalgamating organisations with similar functions where this was appropriate:

Mr WHITE:.... The Committee may want to consider the examples of smaller agencies that do similar types of activities. For example, eight boards come under the umbrella of a group called the Health Professional Board, which includes dental technicians, nurses, et cetera. Each is a reporting entity and, therefore, has a separate set of accounts. It may be useful to consider amalgamating those eight into one. Currently the eight have an audit fee of \$27,000, because there are eight sets of accounts. Clearly one set of accounts for all entities added together probably would not come to an audit fee of \$27,000, it would certainly be less than that.⁵²

4.100 CPA Australia preferred restructuring agencies to achieve administrative efficiencies to fundamental changes to reporting requirements. Ms Naomi Carroll, CPA Australia's Technical Adviser for Accounting and Audit told the Committee:

Ms CARROLL: CPA Australia is not averse to change in the system but believes that other more efficient processes could be introduced to ensure maximum value for money—to get you more bang for your buck. A number of such processes are mentioned in our submission. I will mention two examples: first, the merging of agencies by subsuming the activities of smaller agencies into larger authorities. The rationale for doing that is that the activities in larger entities that are small or very small will be subject to the control environment and controls that operate within that large organisation. The second example is to implement shared-service arrangements, whereby the financial reporting functions and even day-to-day accounting for small agencies are centralised to obtain benefits from economies of scale. While not averse to some change in the system, CPA Australia will not support a compromise on aspects of transparency and accountability within the current reporting framework. The reason is simple: these aspects are fundamental to the effectiveness of the public sector and our system of parliamentary democracy. CPA Australia believes that the preparation and audit of financial statements is required to achieve these outcomes.⁵³

4.101 The Committee notes that decisions about the need for an agency to be a separate entity are a matter for the Government and responsible minister to decide and that agencies are established for a variety of reasons. For instance, in the case of the Agricultural Scientific Collections Trust, it may seem logical to amalgamate it with the Department on the grounds of efficiency however a witness from the then Department of Agriculture told the Committee that there were some advantages in maintaining the Trust as a separate entity:

⁵⁰ eg submission No 1 anonymous, submission no 5 Qld Audit Office, Submission No 10 CPA Australia

⁵¹ Submission No 4, NSW Treasury, Appendix 3

⁵² Mr Lee White, transcript of hearing p 49

⁵³ Ms Naomi Carroll, CPA Australia, transcript p 24

Mr McLEAY: A submission suggested that host agencies such as Agriculture could take control for auditing purposes. Obviously that would be a burden on the department. The agencies may be concerned about losing their independence and autonomy. Would that be a capacity that you could see?

Mr HEFFERNAN: I think the line between what is the Department of Agriculture and, say, the Agricultural Scientific Collections Trust is quite blurred. I am not sure that if the Department of Agriculture did that audit that we would have the transparency that we have with the current arrangement. It probably would be important to have independent audit.

Mr McLEAY: So that is the price you pay for independence, basically?

Mr HEFFERNAN: Yes.⁵⁴

4.102 However, as pointed out by witnesses from Treasury, where costs are burdensome there should be a process of reviewing the continued need for an agency. A witness from Treasury noted:

CHAIR: Are you happy about the fact that some agencies are spending a lot of their money on audit fees rather than spending money that has been allocated to them in the provision of services?

Mr NEALE: As Martin said, we have found in the past that audit fees are not an exorbitant cost on agencies. They are declared in their accounts each year. We think it is a necessary cost. When one is involved in running financial affairs one is audited and one pays for an auditor. If you have a particularly small agency that is incurring a lot of money in audit fees for a small amount of revenue, the question that arises is whether that agency is subeconomic. Someone might have to look at the overall structure of those sorts of agencies. If they are subeconomic perhaps they should combine with other entities.⁵⁵

4.103 The Committee considers that, on a case by case basis, individual agencies should consider their structural arrangements if compliance costs of reporting and auditing costs are excessive. In Chapter Three, very few cases were identified where auditing costs were greater than 5% of an agency's income. This is a useful benchmark for assessing the continued viability of an agency.

RECOMMENDATION 6: Ministers should review the suitability of the structure of the organisations that they control taking into consideration accountability, as well as legislative and service delivery constraints, on a regular (ideally annual) basis. At a minimum, the structure of an agency should be reviewed when the auditing costs become more than 5% of whichever is the smallest of its income or its expenses or its assets.

4.104 The Committee also heard that the issue of administration and compliance costs specifically related to reporting and auditing are not separately assessed when an entity is established:

CHAIR: When a small agency is set up does Treasury provide advice regarding the efficiency of reporting and audit?

Mr NEALE: Not normally.

Mr SMITH: Small agencies reporting receive Treasury circulars and they can look at our web site. Occasionally we have seminars. We had one earlier in the year to do with the

⁵⁴ Mr Tony Heffernan transcript of hearing p 14

⁵⁵ Mr Ian Neale transcript of hearing p 35

updated accounting requirements under Australian and international standards. As far as audit arrangements are concerned they will speak to the audit team about that.

Mr NEALE: An entity may be established by any one of the Ministers, basically, putting out a Cabinet minute with legislation establishing the organisation and at the time there are policy reasons why they want that particular organisation established. Basically, we will comment on the financial aspects but we do not get into the level of audit fees on a particular entity.⁵⁶

4.105 Later Mr Neale commented:

Mr NEALE: Normally trusts are set up for other policy reasons more so than the issue of audit fees per se. You make a valid point that when one is setting up a small entity one should be looking at the overheads in running that entity. We would normally like to see such a trust being serviced by the parent body, if you like, so that they are providing the services to that entity and they probably also would be providing internal audit services and the like. If the Auditor-General were satisfied that there was a good governance regime in place the level of auditing that one has to do in a small agency like that would be fairly small. Therefore, the cost probably should be fairly small too.⁵⁷

4.106 The Committee considers that there could be significant efficiency gains if the full cost of complying with reporting and auditing requirement is assessed prior to establishing agencies.

RECOMMENDATION 7: Guidelines should be developed by the Premier's Department to assist Ministers and agencies to consider the full costs of complying with financial and annual reporting requirements prior to establishing an agency. In particular, consideration of reasons for establishing as a separate entity should be balanced against the marginal cost of auditing decreasing with the increasing size of the agency.

Administrative improvements – Rural Lands Protection Boards

4.107 As discussed in Chapter Three, the Rural Lands Protection Boards have faced significantly increased costs as a result of changes to their accountability arrangements by inclusion in schedules to the PFAA. The Committee considers the experience of the boards in moving to the new reporting arrangements to be far from effective and reflects an inappropriate balance between accountability for public funds and efficiency.

4.108 Representatives of the State Council of Rural Lands Protection Boards have asked that the Committee recommend that the Boards be removed from coverage by the PFAA. The Committee notes that it was a policy decision by a Minister to include the boards under the Act and that the Committee is specifically prevented from commenting on Government policy unless it has been requested to do so.

4.109 However, the Committee believes there may be a way to reduce the compliance burden for the boards. A large proportion of these problems arise from the timing of the reporting requirements under the *Rural Lands Protection Act 1998*.

4.110 Mr Steve Orr, the CEO of the State Council, described the difficulties of meeting the timing required by the new arrangements:

⁵⁶ Mr Ian Neale transcript of hearing p 38

⁵⁷ *ibid* p 39

Mr ORR: One of the issues is that under the annual reports legislation we must prepare an annual report. The Rural Lands Protection Act gives State Council some discretion as to how that occurs. Our Act provides that if boards submit information in their reports about what they have achieved for the previous year, each individual board does not need to submit an annual report in its own right. We submit a combined annual report for all boards. That is the current system. One of the issues we struck this time around was that our annual report submission date is 30 April. We need to include in that report financial data about the performance of boards. We do not get that data until more or less the end of June. We are required by statute to prepare and submit an annual report by 30 April, but we do not get the information we need until two months later. This time we have been given an extension to the end of July to submit our annual report so that we can include the financial data. At the same time, the Auditor-General's report to Parliament regarding our financial statements covers board accountability and how boards have performed. If the Auditor-General is going to do that, that covers the financial issues.

If we submit our annual report by 30 April we are not a position to provide all the financial data because we do not have it at that time. It is double reporting whereby the Auditor-General is making a report on the boards' financial performances and the annual report can deal with other things such as performance measures and the like associated with the board system. If that is to be submitted by 30 April we say it is not essential to have the annual report covering that data because we do not have it at that time. That might be a long-winded answer, but that is one of the reasons. We do not have the information regarding financial performance of boards in time to report in that time frame.⁵⁸

- 4.111 He suggested that the Boards should have a standing extension for the preparation of annual reports until 30 July.
- 4.112 Sections 33 and 53 of the *Rural Lands Protection Act 1998* provides that the financial year for the boards and the state council commence on 1 January. However it notes that the Treasurer has the power to determine a different reporting period under section 4 1(A) of the *Public Finance and Audit Act 1983*.
- 4.113 An alternative arrangement would be for the reporting period to be altered to commence on 1 July or another date that was easier for the boards to meet and obtain qualified financial assistance.
- 4.114 This approach, in tandem with the Auditor-General's follow-up procedures for managing contract auditors should assist the boards in meeting their accountability obligations in a more cost effective way.

RECOMMENDATION 8: The Minister for Primary Industries should propose amendments to the *Rural Lands Protection Act 1998* in order to change the date for the financial and annual reporting for the Rural Lands Protection Boards to a more administratively convenient date. In the short term, the Minister should request the Treasurer to determine a more convenient reporting date.

REVIEW OF INVITED AUDITS LIST

- 4.115 The "invited audit list" is contained in clause 20 of the *Public Finance and Audit Regulation 2000*. This list represents agencies that the Treasurer or a Minister has

⁵⁸ Mr Steve Orr transcript of hearing p 6

requested the Auditor-General to audit, that the Auditor-General would not necessarily otherwise have the mandate to audit.

4.116 There are currently 46 organisations and 13 funds listed for this purpose in the regulation. While some of these, such as the Art Gallery of New South Wales Foundation and the Macquarie University Professional Superannuation Scheme, are large and complex, many are not. As noted above, it may be appropriate for some of these to be exempted from the need to prepare general purpose financial statements if they are not administering public funds.

4.117 The Committee heard that there are no criteria for inclusion on this list. There is also no formal process for reviewing the continued relevance of the list. Consequently it is very rare for organisations to be removed from the list:

Mr McLEAY: How does one get on the invited list for the Audit Office to do audits? Does one always remain on that list? Is there criteria for deciding whether they should continue to be audited?

Mr SMITH: It is under sections 44 and 45 of the Public Finance and Audit Act at the request of a Minister or the Treasurer. There is no criteria laid down in the Act as to why the Minister or the Treasurer would request, and perhaps deliberately so, but it just gives them a discretion. It is extremely rare for agencies to come off the list. I have just organised for one to be taken out this year so it does occasionally happen. It would take another request by the Minister or the Treasurer to remove them from the list.⁵⁹

4.118 The Committee considers that this is not an efficient administrative arrangement and may lead to unnecessary compliance costs for agencies. There are two administratively simple times for addressing the continued appropriateness of the need for this audit. Each year an engagement letter for the audit is issued by the Audit Office. Every five years, there is a statutory review of the regulation.

RECOMMENDATION 9: Engagement letters for “invited audits” (those undertaken under section 45 of the *Public Finance and Audit Act 1983*) should be revised to include a consideration of whether the audit continues to be required.

RECOMMENDATION 10: The Treasurer should write to responsible Minister concerning the continued need for agencies to be included in the “invited audit” list at five yearly intervals prior to the statutory review of the regulation.

⁵⁹ Mr Martin Smith, transcript of hearing p 38

Appendix One – Questions Asked in Discussion Paper

1. Who are the users of financial and annual reports? The Parliament? The Government? The public?
2. Do the Parliament and the public need to know the detailed financial circumstances of very small entities?
3. Does the need for accountability for public money and assets outweigh any possible efficiency gains by reducing the number of agencies required to prepare reports and be audited?
4. Would there be any benefit in reducing the level of scrutiny for small agencies? If so, what criteria would be appropriate?
5. Is it essential to maintain a link between financial reporting requirements and the need to prepare an annual report?
6. Would the State's financial reporting be subjected to any additional risks by creating differential levels of reporting?
7. Who should review classifications under a system of differential reporting? How often? Should these reviews be subject to Parliamentary scrutiny?
8. What level of resources are required to prepare annual and financial reports? Is this onerous for small agencies?
9. Would it be appropriate to enable smaller, low risk agencies to prepare less comprehensive financial reports?
10. If so, what criteria would provide the right balance between risk and accountability?
11. What should be included in a concise financial report?
12. How often should decisions be made about an agency's reporting requirements?
13. What are the risks if the level of audit for small entities is reduced?
14. Has the Audit Office added any benefit by performing reviews of very small agencies included in the PFA Regulations by identifying accounting control problems or other financial management issues?
15. Who should decide whether organisations are subject to this level of scrutiny? The Government? The Treasury? The Parliament?
16. What should be the criteria for deciding the reporting requirements for agencies? For instance, should it be the size of the budget, assets or whether their activities are commercially focussed?
17. Should there be a regular revision of the organisations included in the invited audits list?

Appendix Two – List of Submissions and Correspondence Received

No	Provided by	Subject
1	Anonymous	Submission in response to Committee's discussion paper
2	Mr Chris Puplick, Privacy Commissioner, Privacy NSW	Submission in response to Committee's discussion paper
3	The Hon John Watkins MP, Minister for Education and Training	Submission in response to Committee's discussion paper
4	Mr Ian Neale, Executive Director, Financial Management Directorate, NSW Treasury	Submission in response to Committee's discussion paper
5	Mr V P Manera, Acting Auditor-General of Queensland	Submission in response to Committee's discussion paper
6	The Hon Richard Amery MP, Minister for Agriculture	Submission in response to Committee's discussion paper
7	Mr R J Sendt, Auditor-General of New South Wales	Submission in response to Committee's discussion paper
8	The Hon Kim Yeadon MP, Minister for Information Technology, Minister for Energy, Minister for Forestry, and Minister for Western Sydney	Submission in response to Committee's discussion paper
9	Mr Steve Orr, Chief Executive Officer, State Council of Rural Lands Protection Boards	Submission in response to Committee's discussion paper
10	Mr Mark Hoddinott, President, NSW Divisional Council, CPA Australia	Submission in response to Committee's discussion paper
11	Mr K M Brown, Director-General, Department of Gaming and Racing	Submission in response to Committee's discussion paper
12	Ms Robyn Kruk, Director-General, NSW Department of Health	Submission in response to Committee's discussion paper
13	Mr Bill Barneston, Chairman, Wollongong Sportsground Trust	Submission in response to Committee's discussion paper
14	Mr Steve Orr, Chief Executive Officer, State Council of Rural Lands Protection Boards	Supplementary submission relating to issues raised at public hearing on 15 July 2003
15	Mr Ian Neale, Executive Director, Financial Management Directorate, NSW Treasury	Correspondence of 29 August 2003 responding to questions asked by the Committee at the public hearing
16	Mr Adam Awty CPA, Director of Public Sector, CPA Australia	Correspondence of 15 September 2003 responding to questions arising from the public hearing
17	The Hon Michael Egan MLC, Treasurer	Correspondence of 2 October 2003 responding to the Committee

Appendix Three – List of Witnesses at Hearing

15 July 2003, Parliament House

Organisation	Representatives
State Council of Rural Lands Protection Boards	Steve Orr, Chief Executive Officer Rowan Moore, Chairman
Department of Agriculture	Tony Heffernan, Chief, Division of Corporate Services Nick Milham, Program Leader, Industry Policy Allan Everett, Economic Services Unit Dr Murray Fletcher, Director, Agricultural Scientific Collections Trust
NSW Health	Ken Barker, Chief Financial Officer
CPA Australia	David Pendleton, FCPA, Director of Finance and Support Services, ABC, (Member NSW Divisional Council and NSW Public Sector Committee) Naomi Carroll, Technical Adviser, Accounting and Audit Cath Mulcare, Policy Adviser, Corporate Reporting
Treasury	Ian Neale, Executive Director, Financial Management Directorate Martin Smith, Principal Policy Analyst
The Audit Office of NSW	Tony Whitfield, Deputy Auditor-General Lee White, Assistant Auditor-General, Financial Audit