

Public Accounts Committee

Parliament of New South Wales

Report on Performance Review Practices in  
Government Departments and Authorities



## CHAIRMAN' S FOREWORD

The Public Accounts Committee is centrally interested in value for money and accountability. Its concern is that Government organisations should account to Parliament for the efficiency and effectiveness of their operations.

In our Seventh Report, the Committee examined the annual reporting requirements of statutory authorities. The emphasis then, and now, is that improved accountability to the Parliament, and consequently to the public, will result from more complete, clear, annual reporting. Legislation has been passed embodying most of the recommendations of that Report and it is expected that this will be extended to departments in the next session of Parliament.

In this Report, the focus is on internal audit and performance review practices. The Public Accounts Committee is interested primarily in management accountability: the heads of departments and authorities are now legally accountable for ensuring the efficiency, effectiveness and internal control of their organisations' operations. Here we examine what measures are taken internally to monitor, control and improve performance.

As part of management accountability, the Committee examined objectives and performance measurement, management improvement plans, management information systems and internal audit and performance review.

Particular attention was paid to the role and scope of internal audit, the qualifications and experience of internal audit personnel and the services available at the central agency level to advise on internal audit and programme evaluation. We also canvassed briefly the relationship between internal and external review.

The main substance of this inquiry is based on a questionnaire that was sent to all Government departments and statutory authorities that receive funds from the Consolidated Fund; that is, directly from the annual Budget. Questions were asked about objectives, performance measurement, internal review practices and costs.

The then Chairman of the Public Accounts Committee, Mr. Michael Egan, was particularly concerned that these organisations account to the Parliament for their efficiency and effective administration. He considered that such a broad-ranging questionnaire, the first of its kind from a Parliamentary Committee in Australia, might in the future be a regular part of the Committee's holding of departments to account. Up until that time, the focus of the Committee's attention had been on statutory authorities.

Whether or not such searching questionnaires will be sent biennially or triennially will, of course, be a decision for the Public Accounts Committee to make at the appropriate time. The premise was then and is now that such an exercise in accountability must necessarily itself improve performance in public administration in New South Wales.

There is little doubt that Parliamentary scrutiny must sharpen the wit and resolve of public servants in performing their tasks. Information from the questionnaires has not only served as a basis for this inquiry but also as resource material in examining the operations of individual organisations.

I would like to recognise the central role played by the Government, and particularly by the Treasurer, the Hon. Ken Booth in giving impetus to the development of internal control and review mechanisms in N.S.W. government organisations through the enactment of Section 11 of the Public Finance and Audit Act.

I would like to acknowledge Mr. Michael Egan's significant contribution as former Chairman in originating the wide-ranging questionnaire and this inquiry.

I would also like to thank Mr. John Bragg, Managing Director, and Mr. Leigh Minehan, Partner, of Coopers and Lybrand W.D. Scott Services, Management Consultants for their contribution.

I also wish to note the hard work of the Committee's stenographers, Sandra Vine and Christina Assargiotis and the helpful comments of the Committee's Director, Frank Sartor, and Bob Pritchard from the Auditor-General's Office.

Finally, I would like to extend a special thanks to the former Deputy Director, Ruth Tait, for her excellent contribution in directing the inquiry and in the drafting of the report. This has been Ruth's last contribution to the Committee's work as she is leaving us to take up an appointment with the Maritime Services Board. Her work with the Committee has been of an exceptionally high standard and we will sorely miss her. The Public Accounts Committee extends to her our best wishes in her new endeavours.

John J. Aquilina Chairman



## CONTENTS

Section No.		Page
1	Summary of Conclusions and Recommendations	1
2	Introduction	21
	Terms of reference	
	Approach to the review	
	Questionnaire	
	Public Hearings	
	Submissions	
	Terminology	
3	Management Accountability	29
	Legislated accountability of management	
	Objectives	
	Performance measurement	
	Management improvement plans	
	Management information reporting systems	
	Internal audit and performance review	

## CONTENTS (Continued)

Section No.		Page
4	Role and Scope of Internal Audit & Performance Review	49
5.	Central Agency Involvement in Internal Reviews	71
6	The Relationship Between Internal and External Reviews	79
7	Organisation	87
8	Human Resources	91
9	Approach, Methodology & Standards	97
10	Implementation	105

## Appendices

- A Organisations Surveyed
- B Questionnaire Results
- C Experience in Other Governments
- D Glossary of Terms
- E Witnesses before the Public Hearings



## 1 SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

### INTRODUCTION (Section 2)

1.1. Never has the need for government accountability been so compelling. With over 42% of Australia's Gross Domestic Product now consumed by the public sector compared with 37% in 1975 and 28% in 1950, there is escalating pressure for taxpayers to be given not only assurance, but demonstrable evidence that value for money is being obtained from public spending.

1.2. Fundamental to the accountability of each government organisation is a system of internal review designed to critically and independently assess and report on the extent to which the organisation is meeting its objectives efficiently and effectively. Management must be directly accountable for the efficiency, effectiveness and internal control of the organisation.

### MANAGEMENT ACCOUNTABILITY (Section 3)

1.3. The N.S.W. Government has clearly committed itself to management accountability - by making the heads of all departments and authorities accountable to the Minister for the efficient, effective and economical management of the functions, activities and internal control of their organisations. This has been accomplished by two recent pieces of legislation, the Public Service Act, 1979 and Public Finance and Audit Act, 1983.

1.4. The Committee considers that objective setting and performance review are functions of management and accordingly recommends that each department/authority required continually to review the performance of its organisational units and programs as part of its ongoing line management process.

## Objectives

1.5. The now legislated and acknowledged accountability of management for achieving value for money has led to recognition of the need for improved performance measurement and reporting in the public sector, both to assist management in monitoring its effectiveness and efficiency, and to demonstrate this performance to the public.

1.6. A prerequisite to performance measurement is the definition of a performance standard, or objective, against which actual results can be compared.

1.7. The recent introduction of program budgeting in N.S.W. has prompted authorities to begin developing statements of program objectives, but the questionnaire revealed that the quality or focus of the objectives is variable. Most program objectives cited were not true objectives setting out the results or outputs to be achieved, but rather, statements of functions, describing what the organisation does.

1.8. The Committee recommends that the relevant Minister should require each department/authority head to develop and maintain current measurable objectives for the department/authority, reflecting the aims of legislation and current government policies. The management objectives should include, but not be restricted to, the statement of program objectives developed for program budgeting. Managers should be responsible for providing clear, measurable objectives for their programmes.

## Performance Measurement

1.9. The responses to the questionnaire indicate that the monitoring of performance against objectives in N.S.W. departments relies heavily on subjective judgement, supported by a comparison with budgets and a review of trends.

1.10. By January, 1985, 60% of the organisations indicated that they used performance indicators although rarely was there any explicit relationship between the indicators and the attainment of program objectives.

1.11. The Committee recommends that managers should derive performance measures to determine to what extent program and organisational objectives are being attained efficiently and effectively. Efforts should be made to compare performance measures with some form of standard, such as over time, with other regions, states or countries, or against a standard developed by some external process of consensus (e.g. norms established by U.N. organisations) or from major research projects.

1.12. For each external objective, the head of authority should be required by the relevant Minister to identify the key performance measures by which achievement of that objective may, to some reasonable extent, be demonstrated.

1.13. Where an organisation provides a service directly to the public, it is particularly important that measures of performance be reported with regard to the satisfaction of public demand.

1.14. The Committee believes that it is essential that the objectives of organisation be clear and publicly revealed.

1.15. In the present absence of the regulations under the Annual Reports (Statutory Bodies) Act, the Committee again recommends :

(a) That departments and authorities be required to publish their external objectives in their annual reports.

(b) That, where practicable, key performance measures be required to be published in the annual reports of statutory authorities and departments.

## Management Improvement Plans

1.16. The Committee supports the development by authorities of annual management improvement plans as required by the Premier, which it regards as an essential part of management's responsibilities. The Committee observes, however, that planning, while an essential first step, does not, in itself, discharge management's responsibilities -planning needs to be followed by careful monitoring and achievement of results.

## Management Information Reporting Systems

1.17. Adequate management information reporting systems are an integral part of sound management. From the questionnaire responses received by the Committee, it was clear that many departments do not have well developed internal management information systems.

1.18. In the Committee's opinion, management reporting systems can and should be designed to report on:-

- (a) the extent to which the objectives of the organisation (or program) have been achieved;
- (b) whether those objectives that have been achieved, have been achieved at reasonable cost, by reference to planned and comparative performance standards.

1.19. Internal audit and review mechanisms should monitor the adequacy and validity of management reporting systems, but are not a substitute for those systems.

1.20. A comprehensive performance reporting system should embrace both inputs and outputs. That is, it should cover resources used (financial reporting) and results achieved (effectiveness). Comparisons of outputs with inputs then provide the basis for reports on efficiency. All reports should compare performance with a standard, target or other objectives.

1.21. The Committee recommends that heads of authorities ensure that they have adequate internal management information systems to enable them and their management to monitor the effectiveness, efficiency and economy of their operations.

1.22. In its initial questionnaire, the Committee was concerned to monitor the incidence of sick leave, overtime and workers' compensation claims in the departments surveyed.

1.23. The Committee was concerned about the high incidence of workers' compensation claims, sick leave and overtime in some organisations. Although the averages for workers' compensation, sick leave and overtime levels are not extremely high, the Committee remains concerned about high levels in certain organisations and for certain groups. The Committee therefore foreshadows that it will further inquire into these areas within the next twelve months.

#### Internal Audit and Performance Review

1.24. Given the clear responsibility and accountability of the head of an authority to achieve an adequate level of performance against objectives in terms of effectiveness, efficiency and economy, and to ensure adherence to prescribed financial and other regulations of government, the relevance of and need for some form of internal performance review mechanism has been recognised by most authorities and this issue is examined in the rest of the report.

#### ROLE AND SCOPE OF INTERNAL AUDIT AND PERFORMANCE REVIEW (Section 4)

1.25. Of the organisations covered by the questionnaire 34 (79%) reported the existence of an Internal Audit section by January 1985 (32 in 1983). Over half of the organisations identified the existence of separate units reviewing efficiency and effectiveness. However, further investigation indicated that these units were either working on an ad hoc basis conducting one off special tasks or involved in implementing organisational and systems improvements, rather than a regular and comprehensive program of reviews.

1.26. From the results of the questionnaire and from the public hearings and submissions received from interested parties, it was evident that the current function of internal audit is mainly directed to financial and compliance auditing. Internal audit units to date have had little involvement in efficiency and effectiveness auditing.

1.27. The results of the original questionnaire indicated that approximately 78% of total internal audit time is currently directed to the financial and compliance audit area. The results did not change significantly between the times of circulation of the original Public Accounts Committee questionnaire and the follow up questionnaire in January 1985.

1.28. While the Public Finance & Audit Act legislation has sought to clarify the responsibilities of management, it has left two questions on the role and scope of internal audit open to debate:-

(I) by requiring that the head "wherever practicable, shall establish and maintain an effective internal audit organisation" the question arises of what discretion is implied by the words "wherever practicable" i.e. to what extent is it mandatory to have an internal audit organisation?

(II) if the organisation has an internal audit organisation, must it include the three functions of: financial compliance; efficiency/economy; and effectiveness auditing?

1.29. In examining the first issue, the Committee recognises that the head of a department or authority is specifically charged with maintaining an effective system of internal control over the financial and related operations of the authority. In addition, the head is also charged with the responsibility, wherever practicable, to maintain an effective internal audit organisation.

1.30. In the Committee's view, internal audit forms part of management's overall system of internal control, regardless of the statutory requirement to maintain an internal audit organisation.

1.31. In assessing the relevance of internal audit in the management of the public service, the Committee recognises that a particular type or level of internal performance audit mechanism cannot be regarded as mandatory. To make it so would be to compromise the responsibility of management. It is arguable that the phrase "wherever practicable" in the Public Finance and Audit Act, permits that the head of an authority could rightly decide, in the interests of economy, not to maintain an internal audit or other internal performance review function, provided he/she was satisfied and could demonstrate to any external review function that there existed:-

- (a) a sound structure of objectives, organisation, management delegation and resources;
- (b) an effective and comprehensive system of internal controls;
- (c) adequate management information reporting systems to enable performance to be measured and monitored on a timely basis for decision making before adverse trends become material.

1.32. The Committee considers however that the ideal management system is extremely unlikely to be achieved on a consistent basis over time, and that authorities should be required to maintain internal audit functions, to provide added assurance that major weaknesses have not developed, and to recommend ways of improving performance.

1.33. In the Committee's opinion, the legislation should make clear that the performance of the functions as outlined in Section II (2) are compulsory, although the organisational form of these functions should be left to the discretion of management. Thus the Committee recommends that Section II (2) of the Public Finance and Audit Act be redrafted to clarify that the head of an authority is responsible for ensuring the performance of the functions outlined in the legislation but that the organisational form of the internal audit function be left to the discretion of management. The Committee commends the establishment by authorities of separate internal audit units.

1.34. The second issue which has arisen from the legislation is whether an internal audit organisation, if it exists, must necessarily review efficiency and effectiveness, as well as financial and compliance.

1.35. The arguments in favour of combining these functions are to ensure proper planning and co-ordination of the coverage of reviews, and to avoid duplication and overlap. The arguments against combining these functions relate to the different skills required and the different emphasis.

1.36. The Committee notes that S.II (2) (b) of the Public Finance and Audit Act appears to prescribe that where there is an "internal audit organisation", it shall be responsible for effectiveness, i.e. for reviewing operations to ascertain whether results are consistent with objectives. However, the setting up of the internal audit organisation is discretionary, to be done "wherever practicable" and in the Committee's view this spirit of discretion undermines any prescription of scope for the audit organisation's role. The Committee concludes therefore that the manner in which the various levels of the "comprehensive audit" be organised is at the discretion of management.

1.37. However, the Committee considers that there are significant advantages in giving the audit function the scope to cover the regular review of the whole internal management control and reporting system. As defined early in the report, the three levels of a comprehensive audit include controls over financial propriety and compliance with regulations, efficiency and economy in the use of resources and effectiveness in achieving objectives. All of these management controls are, in the opinion of the Committee, clearly and necessarily interrelated. The emphasis in internal audit developments in many jurisdictions in Australia and overseas (see Appendix C) in recent years, has been to integrate the auditing of these management controls.



1.38. The Committee recommends that heads of departments/authorities be commended to internal audit covering the three levels of comprehensive audit coverage - financial and compliance, efficiency and economy in the use of resources and effectiveness in achieving objectives.

1.39. The Committee considers that when the audit function is expanded to include efficiency and effectiveness, the term "management audit" may usefully be applied to the function. This would remove any narrow connotation traditionally attributed to "internal audit". In addition, it would stress the group's role as a service to management.

1.40. The question arose during the inquiry of whether audit should also undertake ad hoc, consultative types of review. This involves a much more diverse range of objectives, methods and skills, depending on the nature of the problem addressed. While reviews of this type have an important place in the management of many organisations, they serve a different purpose from audit, and are probably better organised and staffed separately from the audit function. Separation of this function also has the advantage of avoiding any dissipation of the regular programme of audit, which can arise from the unpredictable resource demands resulting from urgent ad hoc investigation requests. In addition, audit will not be in the position of auditing the recommendations it has itself made, but will be independent from the problem-solving consultancy group.

#### CENTRAL AGENCY INVOLVEMENT IN INTERNAL REVIEWS (Section 5)

1.41. The Committee concluded that there is little clear, unified direction from the central agencies about the development of comprehensive audit and review in N.S.W. departments and organisations. Although valuable services exist, such as those provided by the Efficiency Audit Division and the Program Evaluation Unit at the Public Service Board, these are not specifically directed at guiding and training internal auditors and reviewers.

1.42. The Committee is concerned that the fragmentation of services at the central agency level may well lead to the fragmentation of the audit/ review function at the organisation level. In addition, the

Committee considers that the fragmentation revealed at the central agency level yields gaps in the provision of advice to organisations about internal audit and review - advice extending to the preparation of policies and plans, staffing senior positions, developing audit methodology and delivering audit training.

1.43. The Committee therefore recommends:

(a) That a unit be established within the Public Service Board to provide direction guidelines and training regarding all levels of comprehensive auditing. This unit might be entitled The Management Audit Advisory Unit.

(b) That the services offered by this unit include:

advice about how to establish audit units, whether they be devoted to financial and compliance matters or be involved in all three levels of comprehensive audit coverage;

advice about the preparation of audit policies and plans;

advice about the staffing of senior positions;

advice about audit methodology;

provision of guidelines about financial and compliance audit (this responsibility should be taken from Treasury) and guidelines about efficiency and effectiveness auditing;

delivery and design of audit training where needed and provision of advice about relevant courses available;

education of senior management about the benefits of comprehensive audit;

(c) That the unit also conduct regular, formal, quality assurance reviews of internal audit/management audit units and recommend improvements to the heads of departments/authorities.

(d) That the Internal Audit Bureau presently with Treasury be attached to this unit/division.

1.44. The Committee considers that an interdepartmental committee might be established to provide coordination and overview of the activities of the Management Audit Advisory Unit. The interdepartmental committee should include representatives from the Auditor-General's Office, Treasury, Public Service Board, Premier's Department and a small number of operating departments/authorities.

1.45. The Committee recognises the existence of the Program Evaluation Advisory Committee and suggests that consideration be given to expanding the membership and role of this Committee to fulfill this need as an alternative to creating another committee.

#### RELATIONSHIP BETWEEN INTERNAL REVIEWS AND EXTERNAL REVIEWS (Section 6)

1.46. The Committee's questionnaire revealed that heads of departments and authorities relied heavily on external reviews by external consultants, the Public Service Board, Premier's Department and the Auditor-General to assess whether or not their organisations were functioning as they should.

1.47. External reviews will of course continue to be necessary, but the new emphasis on internal audit, a form of review which reports directly to management and not to government or to Parliament, will necessarily increase the involvement of heads of authorities in reviewing their own performance.

1.48. The roles of the Public Accounts Committee and of the Auditor-General became an issue during this Inquiry. With regard to the role of the Public Accounts Committee, the power of the Committee to examine issues of efficiency and effectiveness was confirmed by the Crown Solicitor. With regard to the role of the Auditor-General, the Committee concluded that the Auditor-General had in no way attempted to exceed his powers and confirmed the Auditor-General's freedom to audit and report as provided for in the Public Finance and Audit Act.

1.49. Given the Committee's preference for openness in government generally, it questions the necessity of treating the efficiency audit reports from the Public Service Board and the management strategy reviews from the Premier's Department with such secrecy. It is argued by those in favour of restricting access, that the authors of the report would be less frank and hardhitting if the documents were public, and the reviews therefore less useful. However, there is an equally strong argument that public scrutiny will promote constructive action, and act as a stimulus to improved performance.

1.50. The Committee recommends that efficiency audit reports and management strategy reviews be tabled in Parliament within eighteen months of their presentation to the Minister along with the organisation's response and program of action.

1.51. It is important in the future to ensure that any external review is conscious of, and takes into consideration, the degree of internal control and review established by the head of department or authority.

1.52. The Committee considers that liaison between internal audit/review and external audit/review mechanisms is essential.

1.53. The Committee recommends that:

(a) The internal audit charter require regular meetings with the external auditors to co-ordinate the extent, scope and timing of internal financial and compliance audit work conducted.

(b) The internal audit unit liaise with external reviews to ensure their knowledge of the level of internal review performed.

(c) That where an external review has been conducted, the internal auditor/reviewer should conduct follow up reviews to ensure that the recommendations of the external review are being acted upon.

#### ORGANISATION (Section 7)

1.54. The Committee considers that small departments/authorities which cannot justify a team of two internal auditors will probably find it more cost effective to obtain contract internal audit services from the Treasury's Internal Audit Bureau, from private sector professional auditors, or from shared resources with another authority. However, that judgement must remain with the head of authority.

1.55. To be effective in fulfilling the safeguard role, any form of internal performance review needs to be independent of the levels of management being reviewed, otherwise its findings may be compromised along the management line.

1.56. The Committee recommends, therefore, that internal audit report directly to the head of authority or at least have right of direct access.

1.57. The current practice in a number of authorities of using internal auditors as relief staff in accounting or operational areas represents a serious weakness in the organisational structure of these departments, as the internal auditors then lack independence, which could impair their objectivity, as well as prejudicing the audit programs to be completed with given resources and time.

1.58. The Committee recommends that the internal audit unit should be independent of other activities within the authority and should not provide resources as relief staff to other activities.

## HUMAN RESOURCES (Section 8)

1.59. The Public Accounts Committee's questionnaire results revealed that generally, with some exceptions in the larger departments, internal audit staff were not highly graded and remunerated. There was however some improvement in 1984. In 1983 only 4 internal audit managers were grade 9 or above (making more than \$35,000), while at the time of the follow up questionnaire 9 internal audit managers were so graded. Commensurate with the low grades of internal audit positions, the incumbents of these positions were generally not well qualified, with only 57% in 1984 having tertiary qualifications.

1.60. The Committee believes that it is essential to improve the overall stature of internal audit and raise management's views and expectations of its capabilities in order to obtain a commitment from management to provide the necessary skilled resources. There is a need for better planning and co-ordination of internal audit skills and resources.

1.61. The Committee does not consider it appropriate for it to stipulate minimum grades for internal audit nor that it prescribe minimum qualifications. Consistent with the role of advising senior management and reporting to the head of the authority, the heads of management units should themselves to have equivalent status to senior management.

1.62. Further, if internal audit is to serve the broader role of reviewing efficiency and effectiveness, multidisciplinary skills will be necessary in the audit and a sound knowledge of management as a whole. A positive creative approach will also be necessary. Although accounting is essential for financial/compliance auditing it clearly is not mandatory in reviewing efficiency and effectiveness. The qualifications needed will obviously vary depending on the nature of activity audited.

1.63. The Committee recommends:

- (a) That the proposed new Management Audit Advisory Unit provide guidelines on the appropriate grade and the appropriate qualifications for internal audit positions, based on the level and nature of the work they are performing.
- (b) That it be a prerequisite for unqualified staff to undertake an appropriate tertiary course of study and that they operate as assistants to a qualified person while they pursue their studies.
- (c) That all internal audit staff be required to receive not less professional development or training each year than required by professional accounting bodies to supplement their existing knowledge and keep them abreast of new auditing development and skills.

1.64. To attract and retain appropriately skilled employees in the internal audit role the Committee recommends that greater attention be given to career planning. It is necessary that auditors can either:-

- (a) see opportunity for advancement within the internal audit function of their department or authority;
- (b) see opportunity for advancement into a management position within their department or authority; or
- (c) have an opportunity for transfer to a more senior position with another department or authority.

1.65. The Committee recommends that the Public Service Board should address the issue of career planning for internal auditors and act in a liaison capacity for the planning and counselling of internal audit staff within the public sector.

#### APPROACH METHODOLOGY AND STANDARDS (Section 9)

1.66. The submission from The Institute of Internal Auditors -Australia indicates from their status review in November 1983 that approximately 30% of internal audits in N.S.W. government departments are transaction based as opposed to systems based audits. This was a significantly higher percentage than was found to exist for internal audits conducted by Commonwealth Departments in N.S.W.

1.67. In the Committee's opinion, an internal audit approach should be adopted which concentrates audit effort on control rather than validity of historic transactions.

1.68. The Committee therefore recommends: the adoption throughout the N.S.W. public sector of a systems based audit approach whereby the internal auditor examines the total systems by:-

- (a) identifying and evaluating the controls on which management and ultimately the head of the department or authority relies to ensure the information produced is valid, complete and accurate;
- (b) identifying areas where efficiency and economy might be improved; and
- (c) ensuring the security of assets and the completeness of accounting for liabilities.

1.69. That the approach should be formalised, well documented and standard throughout all internal audit functions in the N.S.W. public sector. This approach should adopt a standard methodology which allows the internal auditor to:-



- (a) gain an understanding of the systems, through the use of flow charts or descriptions of systems;
- (b) confirm, before each audit, that the systems continue to operate as documented;
- (c) evaluate the adequacy of controls and allow weaknesses to be reported to management;
- (d) prepare audit programs to test those controls which the audit has identified during the evaluation process;
- (e) test the department's or authority's system of internal control, using the programs developed, and report weakness to management;
- (f) react appropriately to any breakdowns or departures from the systems of internal control.

1.70. While recognising the right of authorities to develop their internal audit function to suit the needs of the organisation's management, the Committee believes a uniform or standardised approach to internal audit in the N.S.W. public sector would not only promote efficiency but would also assist in the overall areas of training and transfer of staff for internal auditors between departments and authorities. In addition, where systems are duplicated between departments or authorities, it would allow for the exchange of documentation, thus reducing the need to re-document the systems in each user department.

1.71. However the Committee is aware of the need not to stifle initiative and the development of new approaches and the standards should be subject to regular review to take into account new approaches developed by organisations.

1.72. The Committee considers that the Treasury's initial guidelines are a useful first attempt at giving general direction to internal auditors within the N.S.W. public sector but has recommended that the proposed new Management Audit Advisory Committee prepare formal guidelines, extending to efficiency and effectiveness auditing.

1.73. In developing these guidelines the interdepartmental committee should have regard to the standards issued by the Institute of Internal Auditors, the Commonwealth Joint Implementation and Interdepartmental Advisory Committees on Internal Audit, and the Government Accounting Office (GAO) of the United States of America and the standards issued by other professional bodies. The Committee understands that the Auditing Standards Board of the Australian Accounting Research Foundation will in the future be putting forward new standards for both private and public sector audits.

#### IMPLEMENTATION (Section 10)

1.74. In the view of the Committee, a phased implementation is likely to prove the most successful. The Committee recommends therefore that each department/authority should be encouraged progressively and within two years to:-

(a) establish an internal audit unit, preferably styled: "Management Audit" unit, responsible to the head of authority, comprising the two functions of:-

(i) financial/compliance auditing

(ii) efficiency/effectiveness reviews;

{b} develop resources and skills, with the assistance of the central agencies as appropriate, to achieve fully effective systems based financial and compliance audit on a comprehensive planned cycle, within two years;

(c) over a similar time frame, develop specialised resources and skills in efficiency and effectiveness reviews, based on the specifications of objectives, performance measurement and management information systems, utilising as appropriate, the advice of the performance evaluation unit, the Public Service Board's efficiency audit division, and/or contract consultants to develop methodology and train staff. If the proposed Management Audit Advisory Unit is created, its service should also be used.

The head of the unit would co-ordinate and plan the activities of the two functions, which could be organised together or separately, as appropriate, in the Authority.



## 2 INTRODUCTION

2.1. Never has the need for government accountability been so compelling. With over 42% of Australia's Gross Domestic Product now consumed by the public sector (if we define public sector to cover federal, state and local government departments and authorities, including public educational and medical institutions) compared with 37% in 1975 and 28% in 1950, there is escalating pressure for taxpayers to be given not only assurance, but demonstrable evidence that value for money is being obtained from public spending. In N.S.W., state and local government spending now accounts for 7% of Australia's GDP, compared with 6% in 1950.

2.2. In common with the growing demand for evidence of value for money, there has been an increasing emphasis on the need for accountability of governments and public administrators.

2.3. The transmission of meaningful information, including financial information, from government to Parliament to the public is an essential requirement of accountability. The Public Accounts Committee, in its Seventh Report examined the upgrading and standardising of the annual reporting requirements of statutory authorities. Legislation has since been passed embodying most of the Committee's recommendations, and this legislation is expected to be extended to departments in the next session of Parliament.

2.4. Also fundamental to the accountability of each government organisation is a system of internal review designed to critically and independently assess and report on the extent to which the organisation is meeting its objectives efficiently and effectively. Management must be directly accountable to the Minister for the efficiency, effectiveness and internal control of the organisation.

2.5. In N.S.W., this thrust towards greater management accountability has been recognised and formalised in two recent pieces of legislation, the:-

1. Public Service Act, 1979 and,
2. Public Finance & Audit Act, 1985.

2.6. The Public Accounts Committee acknowledges that the achievement of value for money depends upon a number of factors, including:?

- (a) the relevance of legislation, policy and programs to public needs (policy or program effectiveness);
- (b) the effectiveness with which public programs are carried out (management effectiveness);
- (c) the efficiency/economy with which authorities conduct the programs (management efficiency);
- (d) the adequacy of public sector management information systems and performance review mechanisms, in monitoring and reporting on the above and stimulating improvement (performance review).

2.7. In recognition of the importance of the new legislation and the theme of value for money and accountability on which it is based, the Public Accounts Committee initiated this Inquiry into internal audit and performance review practices in N.S.W. departments and selected statutory authorities, in accordance with its functions set out in Section 57 of the Public Finance and Audit Act, 1983. Those authorities included in the survey receive appropriations from the Consolidated Fund. The Inquiry does not address 2.6. (a) above, which is a matter of government policy and thus specifically outside the terms of reference of the Public Accounts Committee.

2.8. The Committee has recognised, in conducting this Inquiry, that

there are three main levels of review of the performance of government:

- (a) review of performance of the Government by the public (reflected in public opinion polls and, ultimately, the ballot box);
- (b) external review of the performance of departments/authorities (conducted by the central agencies on behalf of the Government, and by the Auditor-General, the Ombudsman and the Public Accounts Committee on behalf of the Parliament);
- (c) internal review of the performance of management within a department/authority, conducted on behalf of the head of the department/authority, by internal audit and other review units.

2.9. The main thrust of the Inquiry is to assess the relevance and effectiveness of steps being taken internally by authorities (2.8. [c] above) to review and improve their operational and financial performance in response to the new legislation. Consideration is given also to the relationship between the internal review mechanisms of departments and authorities and those external reviews conducted by the central agencies of government (Premier's Department, Public Service Board and Treasury), and the Auditor-General's Office.

#### Terms of reference

2.10. The terms of reference of the inquiry were to examine, inter alia:

- (i) the status of internal audit and related performance monitoring and improvement practices in N.S.W. departments and selected authorities;
- (ii) the adequacy of internal audit and related performance monitoring and improvement practices in N.S.W. departments and selected authorities;

(iii) changes necessary to ensure that internal audit and other performance review mechanisms enable heads of authorities to meet the requirements of Section 11 of the Public Finance and Audit Act, 1983;

(iv) standards for internal audit and control in the N.S.W. public sector.

Performance monitoring and improvement practices were defined broadly to include objective setting, performance measurement, management information systems as well as the operations of internal audit and review units.

#### Approach to the Review

2.11. The Public Accounts Committee was assisted in its Inquiry by the Deputy Director of the Committee and Coopers and Lybrand Services, management consultants. The main methods the Inquiry used to obtain information of current practices within the N.S.W. public sector included:-

- (a) the circulation of an initial questionnaire and a follow-up questionnaire to government departments and selected statutory authorities;
- (b) the holding of public hearings;  
the receipt of submissions from interested parties;
- (d) a review of Commonwealth, interstate and overseas experience;
- (e) interviews with selected heads of N.S.W. statutory authorities and interstate officials.



2.12. The report aims to set out the current status of internal audit and performance review functions in N.S.W. authorities, discuss key issues and make recommendations for improvement.

#### Questionnaire

2.13. The Inquiry is based on a questionnaire that was sent in July, 1984 to all government departments and statutory authorities that receive funds from the Consolidated Fund, i.e. directly from the annual budget. In January, 1985 a supplementary questionnaire was despatched to the recipients of the original questionnaire to update the information collected.

2.14. Of the 44 organisations circulated (Appendix A), two departments were unable to respond in full to the questionnaire: the Department of Finance which was formed during 1982/83, was unable to provide information on all matters covered by the questionnaire; the Department of Local Government was an office of the Department of Local Government and Lands during 1982/83 and the information available separately on that Department was very limited. The follow-up questionnaire was responded to by 43 departments and authorities (the Central Mapping Authority became part of the Department of Lands in early 1985).

2.15. The responses to the questionnaire are summarised in Appendix B, although certain specific findings have been referred to in various sections of this report.

#### Public Hearings

2.16. To obtain further evidence as to the current status of internal audit and related performance review mechanisms within the N.S.W. public sector, the Public Accounts Committee held a series of public hearings in December, 1984. The witnesses called to testify before the Public Accounts Committee were selected so as to give a representative sample of views of government organisations and of interested parties. (Appendix E)

2.17. The organisations called were:-

The Auditor-General's Office

Premier's Department

Treasury

Public Service Board

State Rail Authority

Corporate Affairs Commission

Government Supply Department

Department of Co-operative Societies

Government Printing Office

Forestry Commission

Public Works Department

Education Department

Department of Youth and Community Services

Institute of Internal Auditors

Submissions

2.18. As a result of advertisements in the press seeking submissions from interested parties, submissions were received from the following:?

The Australian Society of Accountants;

The Institute of Internal Auditors - Australia;

Premier's Department;

Public Service Board;

Treasury;

Deloitte Haskins + Sells;

Ernst & Whinney Services Pty,;

Mr. J.J. Dolan;

Mr. S.K. Meadows.

2.19. The views expressed in these various submissions have been taken into consideration by the Committee in developing its recommendations and in some cases referred to in the body of this report.

## Terminology

2.20. There is a variety of terminology used to describe performance review and audit approaches and concepts. The Committee found a number of terms being used differently by witnesses and this confusion over terminology has obviously given rise to some of the current debate on the subject.

2.21. The Committee has considered a number of definitions and has adopted, for the purpose of this report, those definitions which it considers most fairly describe the following terms:-

- \* accountability;
- \* internal control;
- \* performance measurement
  - effectiveness
  - efficiency and economy
- \* internal audit
  - financial and compliance audit;
  - efficiency and economy audit or review;
  - effectiveness audit or review;
- \* program evaluation.

2.22. As understanding of these terms is essential in certain sections of this report, the definitions are raised in the text where they are considered most relevant. In addition, a glossary of terms is provided as appendix D of this report.



### 3 MANAGEMENT ACCOUNTABILITY

3.1. The Committee has adopted the definition of accountability provided in the Report of the Independent Committee for the Review of the Office of the Auditor-General of Canada, (page 9 Ottawa: Information Canada, 1975) as:-

"...the obligation to answer for a responsibility that has been conferred. It presumes the existence of at least two parties: one who allocates responsibility and one who accepts it with the undertaking to report upon the manner in which it has been discharged."

3.2. In the context of management accountability, and the drive for increased effectiveness and efficiency, the purpose of this section is to examine the inter-relationships of management accountability, objectives, performance measurement, management information systems and internal audit and performance review functions in the management of departments and authorities.

#### Legislated Accountability of Management

3.3. The N.S.W. Government has clearly committed itself to management accountability ? by making the heads of all departments and authorities accountable to the Minister for the efficient, effective and economical management of the functions, activities and internal control of their organisations. This has been accomplished by two recent pieces of legislation.

3.4. Section 47 of the N.S.W. Public Service Act, 1979 charges the department head with the overall responsibility to manage the department in an efficient, effective and economical manner. The relevant text of this statutory mandate is quoted below:-

## "General Responsibility of Department Head

47 (1) A department head is responsible to the appropriate Minister for the general conduct and the efficient and effective and economical management of the functions and activities of the department.

47 (2) For the purposes of exercising his responsibility under subsection (1), a department head may take such action as he deems appropriate and is not inconsistent with the functions of the board specified in this Act."

3.5. Section II subsection (1) and (2) of the N.S.W. Public Finance and Audit Act, 1983 amplifies this management responsibility and makes it mandatory for the heads of authorities to ensure that there is an effective system of internal control over the financial and related operations of the authority and wherever practicable that the head establish and maintain an effective internal audit organisation. ("Authority" in the legislation includes departments and tertiary institutions.) "Authority" throughout this report refers to both departments and statutory authorities.

3.6. The responsibility of management is thus clearly established in legislation. Government (the Cabinet) is responsible for determining policy and programs. Management (the head of the authority) is responsible to government, through the relevant Minister, for achieving the policy and program objectives to the extent feasible within the budget allocated by government, and in the most efficient and economical manner.

3.7. The head of an authority, in the Committee's opinion, is responsible for planning, organising and directing the operations and resources of the authority, delegating decision making authority to an appropriate management structure and monitoring and controlling the performance of management in the achievement of objectives. The head of each authority is responsible for translating overall governmental policy and objectives into the level of detail needed for effective

management planning and control, and for ensuring that there are adequate internal controls and management information systems to provide assurance of effectiveness, efficiency, economy and propriety of management in the achievement of objectives.

3.8. This responsibility for effectiveness, efficiency and economy flows on down the line of management throughout the organisation. All managers in the chain of command have a responsibility for setting and achieving objectives, and for evaluating performance.

3.9. Mr. J. Dolan, in his submission to the Committee, put forward the view that in N.S.W. government there exists no inbuilt review by line management on a regular basis of the performance of organisational units. When this line management function is not undertaken, internal audit (if there is such a unit) is left to fulfill this function, i.e. "establish criteria, perform the reviews and recommend appropriate action as a result of the reviews". This results in the transfer of a line management function to internal audit; the performing of reviews at too infrequent intervals and therefore the absence of an adequate internal control system.

3.10. The Committee did not examine the extent to which this practice operates, but agrees that objective setting and performance review are indeed functions of management and accordingly recommends:

That each department/authority be required continually to review the performance of its organisational units and programs as part of its ongoing line management process.

#### Objectives

3.11. The now legislated and acknowledged accountability of management for achieving value for money has led to recognition of the need for improved performance measurement and reporting in the public sector, both to assist management in monitoring its effectiveness and efficiency, and to demonstrate this performance to the public.

3.12. But a prerequisite to performance measurement is the definition of a performance standard, or objective, against which actual results can be compared. The recent introduction of program budgeting in N.S.W. has prompted authorities to begin developing statements of program objectives, but the quality or focus of the objectives is variable. Most program objectives cited were not true objectives setting out the results or outputs to be achieved, but rather, statement of functions, describing what the organisation does. Very few authorities of the 44 examined had clearly enunciated corporate objectives. In only 5 authorities in 1983 was the organisation able to identify overall organisation objectives other than those established for the programs. This had increased to 9 authorities in 1984.

3.13. If management is to be held accountable, it must be against expressed objectives. For this purpose objectives need to be measurable. An objective need not be absolute (i.e. to achieve x units of output), it can also be relative (i.e. to improve or maintain performance against a standard - e.g. last year's or another region's or country's performance). An objective may be in quantitative or qualitative terms. It may be in physical, temporal, social or financial terms, but above all it must be measurable in some verifiable way.

3.14. It is clear that, while some progress has been made in defining objectives consequent upon the introduction of program budgeting, much remains to be done in N.S.W. government in developing the relationship between government policy and the setting of management objectives, at the various levels of management, to enable performance to be measured and value for money to be demonstrated adequately.

3.15. The Committee recommends that the relevant Minister should require each department/authority head to develop and maintain current measurable objectives for the department/authority, reflecting the aims of legislation and current government policies. The management objectives should include, but not be restricted to, the statement of program objectives developed for program budgeting. Managers should be responsible for providing clear, measurable objectives for their programmes.



Performance Measurement

3.16. The responses to the questionnaire indicate that in practice, in N.S.W. departments, the monitoring of performance against objectives relies heavily on subjective judgement, supported by a comparison with budgets and a review of trends. In response to a question about how the organisation evaluated whether its programs were being implemented efficiently and effectively, the following answers were received.

Method of Evaluation of Major Programmes

Method of Evaluation	No. of organisations using method		% of total	
	1984	1983	1984	1983
Subjective judgement	33	25	77	57
Use of performance indicators	26	23	60	52
Other methods	12	6	28	14
Not at all	1	3	2	7
Two or more methods used	21	12	49	27

Performance indicators used included the following:

Number of Organisations using each performance indicator

	1984	1983
Comparison with budget or other targets	13	7
Review of trends	8	7
Indicators specific to the organisation	16	4
Other	10	3
No details supplied	-	2
Specified 2 or more performance indicators	15	-

3.17. By January, 1985, 60% of the organisations indicated that they used performance indicators although rarely was there any explicit relationship between the indicators and the attainment of program objectives. Few organisations identified that they monitored performance by reference to the performance of similar organisations in other states or overseas. However, for example, the Department of Education provided, subsequent to the questionnaire and public hearing, a paper on performance indicators in education, which referred to a comparative study of H.S.C.E. Language Syllabuses and examinations (1980) with London Advanced Level G.C.E. courses which, in the opinion of the Department, "provides a valuable external opinion on the standards of N.S.W. courses".

What is Performance Measurement?

3.18. The measurement of performance in N.S.W. public 'sector authorities is concerned with their :-

- (a) effectiveness in achieving objectives;
- (b) efficiency and economy with which objectives are achieved.

These are important concepts and warrant further discussion.

Measuring Effectiveness

3.19. Effectiveness is an absolute term. An activity is fully effective if it achieves all its objectives. Objectives may be expressed in quantitative, qualitative, physical, temporal, social or behavioural terms. The easiest objectives to express are those in quantitative, physical or temporal terms; the hardest are those in qualitative, social or behavioural terms.

3.20. The difficulty, as evidenced by the responses to the questionnaire, is that few authorities have clearly defined objectives. The enabling legislation often gives only broad statements of function.

3.21. Objectives can be classified into two categories:-

- (a) external objectives - those which relate to stakeholders, customers and the public;
- (b) internal objectives - those which relate to other departments, sections, people within the organisation.

3.22. In terms of value for money, effectiveness is measured only in terms of external objectives. However, performance measurement will often deal with internal as well as external objectives. One of the important difficulties in developing performance measures lies in the distinction necessary between internal and external objectives and between "output" measures and workload or input measures.

3.23. Many output measures have no direct external visibility. For example, the output of one section of a department (say, processed licence applications ready for authorisation) may be the input into another section - that is, they may be intermediate products. For management control purposes it is necessary to monitor the intermediate outputs, although ultimately it is only the final output of the organisation which creates value measurable by external criteria.

3.24. From a value for money point of view, the measurement of effectiveness is concerned only with effectiveness in meeting external output objectives. From a performance measurement point of view, effectiveness should be measured not only at the final output level, but also for management control purposes as each organisational unit completes its work and passes it on as input to another unit.

#### Measuring Efficiency and Economy

3.25. Efficiency and economy are relative terms. A unit or program can be said to be relatively efficient or economic only in relation to some standard or yardstick. The standard may be a prior period, a

different but comparable program or unit, perhaps in another region or country, or a derived or synthetic standard based on experience and observation.

3.26. Efficiency relates to the conversion of inputs to outputs. A unit or program is more efficient than the standard if it achieves its actual outputs using less inputs (or, in money terms, lower cost) than the standard for that output. (Whether the actual output achieved is equal to the planned output, is a measure of effectiveness, not efficiency.)

3.27. Efficiency is often measured in terms of :-

(a) unit costs of products or services;

(b) person hours per unit of output;

(c) equipment costs per unit of output;

(d) asset capacity utilisation ratios.

3.28. Economy in this sense is really a subset of efficiency. It is popularly used to describe the objective of acquiring resources (or inputs) at least cost, measured by the relative unit cost of purchases, wages, finance etc.

3.29. In a large organisation or program there is usually no simple, overall measure of efficiency or economy. Many different measures and ratios are necessary to give a reasonable indication of relative efficiency. The key word is relative, because efficiency measures in themselves, unless compared with a standard, are of little help in assessing value for money.

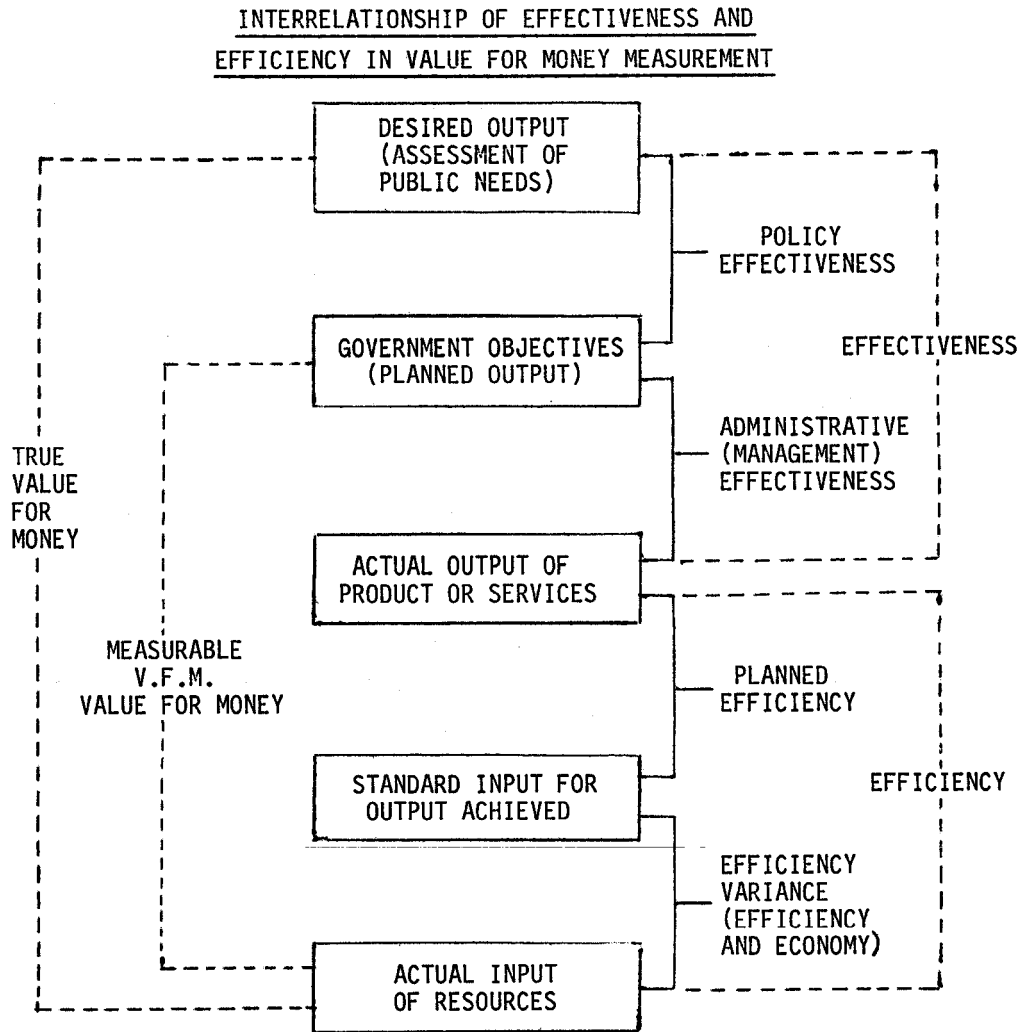
3.30. To be of value, efficiency and economy performance measures need to be built into the whole planning and budgeting process. Management is then required to plan for the level of performance to be achieved (based on comparisons with a standard) and systems can be developed to report the performance achieved compared with plan.

The Interrelationship of Effectiveness and Efficiency

3.31. In assessing value for money, it is insufficient to focus on either effectiveness or efficiency alone. A program can be most effective in achieving its output goals, but at such high cost that it presents little or no value for money. Equally a program can be conducted most efficiently and economically, yet provide little value for money, i.e. its outputs are not effective in meeting public needs.

3.32. The critical interrelationship of needs, objectives, effectiveness and efficiency are illustrated in the following diagram provided by the Committee's consultants, Coopers & Lybrand Services.

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3.33. The measurement of performance, therefore, requires a careful analysis of:-

- (a) objectives (expressed as external outputs);
- (b) effectiveness in achieving planned objectives;
- (c) relative efficiency and economy in converting inputs to outputs, compared with a standard.

3.34. While there was some acknowledgement by most witnesses of the need for performance indicators, there was some concern about the feasibility of developing meaningful measures in relation to many programs, particularly those programs of a social or research nature.

3.35. There is little doubt that difficulty in developing performance measures arises in departments and in divisions of departments which do not provide services directly to the public.

3.36. Further, concern was expressed that undue emphasis on a particular set of performance measures could lead to management action to maximise those measures reported, to the exclusion of others, and lead to sub-optimisation overall.

3.37. While acknowledging the difficulties of developing suitable performance measures in relation to some functions of government, the Committee is of the view that performance measurement is an essential part of sound public sector management. To abandon performance measurement because of its difficulties, would be to resile from management accountability, because in public sector management, except in commercial undertakings, there is no other means (such as profitability in the private sector) available to demonstrate that value for money has been achieved.

3.38. The Committee recommends:

That managers should derive performance measures to determine to what extent program and organisational objectives are being attained efficiently and effectively. Efforts should be made to compare performance measures with some form of standard, such as over time, with other regions, states or countries, or against a standard developed by some external process of consensus (e.g. norms established by U.N. organisations) or from major research projects.

3.39. For each external objective, the head of the authority should be required by the relevant Minister to identify the key performance measures by which achievement of that objective may, to some reasonable extent, be demonstrated.

3.40. The Committee notes that the draft regulations under the Annual Reports (Statutory Bodies) Act, 1984, included the requirement that statutory authorities publish objectives and where practicable, performance indicators in their annual reports. The Committee had recommended this in its Seventh Report on the Annual Reporting Requirements of Statutory Authorities and the Committee supported these draft regulations in its Thirteenth Report. It is anticipated that the legislation on annual reporting requirements will be extended to departments during the next session of Parliament. The Committee notes that the Public Bodies Review Committee in Victoria recommended that the objectives of government bodies should be enshrined in their enabling legislation. The Committee also believes that it is essential that the objectives of organisations be clear and publicly revealed, but concludes that the publication of objectives in annual reports serves this purpose, while allowing flexibility for change.

3.41. In the present absence of the regulations under the Annual Reports (Statutory Bodies) Act 1984, the Committee again recommends :

3.42. That departments and authorities be required to publish their external objectives in their annual reports.

3.43. That, where practicable, key performance measures be required to be published in the annual reports of statutory authorities and departments.

#### Management Improvement Plans

3.44. The Premier of N.S.W. has recently required that management improvement plans be developed by departments. The Premier noted that authorities may also choose to prepare such plans as a means of improving the management of their organisations.

3.45. Each plan is to focus on a few "operational or policy initiatives, with specific objectives and targets, achievements of which can be measured over a defined period". The preparation of plans is not considered to require additional resources and the plans are intended to complement the existing review of objectives and performance by Ministers and department heads. In addition, the management improvement plan and the extent to which its objectives were achieved are to be included in each annual report.

3.46. The Reid report on the Review of Commonwealth Administration recommended that authorities prepare annual management improvement plans, specifying the actions they plan to improve internal management effectiveness and efficiency. The Commonwealth Government's intention to introduce management improvement plans was described in its paper "Reforming the Public Service".

3.47. Recently the South Australian Government received a report on the "Review of Public Sector Management" (the "Guerin Report", February 1985), which recommended the development of management improvement plans.

3.48. Management improvement plans were supported by Mr. G. Gleeson, Head of the Premier's Department in N.S.W. who said, in his submission to the Inquiry:-



"One proposal for ensuring continued devotion to improved administration is the concept of an annual departmental management improvement plan. Such a plan could be associated with the department's annual report, and would focus Ministerial and departmental attention on the achievements and failures of the departments.

Such plans would be closely associated with existing measures directed at management improvements. One major objective would be concerned with the setting of priorities and development of operational strategies.

Plans would reveal the implementation of decisions by the government and would be comprehensively discussed with the Minister.

The involvement of the Minister can make a major contribution by allowing the Minister to provide leadership as to the direction and priorities of the Department. It also provides an opportunity for the Minister to get an overview of the Department without an undue involvement in the minutiae."

3.49. The Committee supports the development by authorities of annual management improvement plans, which it regards as an essential part of management's responsibilities. The Committee observes, however, that planning, while an essential first step, does not, in itself, discharge management's responsibilities - planning needs to be followed by careful monitoring and achievement of results.

#### Management Information Reporting Systems

3.50. Adequate management information reporting systems are an integral part of sound management. Just as performance against objectives needs to be measured, it needs to be reported in a timely organised way, at appropriate intervals, to the managers responsible. Management needs an early warning system to alert it to any breakdowns

in controls, or changes in circumstances, that warrant action to ensure that objectives are achieved. Reports should be designed so that corrective action can be taken to overcome any adverse trends as they develop.

3.51. In evidence before the Public Accounts Committee, Mr. David Hill, head of the State Rail Authority, held that, in his opinion, a comprehensive management information system was more effective than an internal audit or review function in monitoring and improving performance. He said:-

"To achieve better standards of performance in statutory authorities in New South Wales, I believe the use of the concept of efficiency auditing is weaker than the organisations themselves setting internal management systems and targeting ...

"... you cannot solve efficiency problems in large statutory authorities with armies of efficiency audit teams scanning the system. If these problems are to be solved there must be decent management information systems where every area of management has, first of all, an effective measure of how well or how bad it is doing and, second, some targets that they are pursuing. That has to be reviewed at executive level on an on-going basis. That represents 99% of the method by which the State Rail Authority is trying to improve its performance."

3.52. From the questionnaire responses received by the Committee, it was clear that many departments do not have well developed internal management information systems. Indeed, one Department, Youth and Community Services, was unable to provide any statistical information about the number of employees, workers' compensation, sick leave and overtime. The new management of the department is addressing the need for management Information systems as a priority and the Committee will

#### Internal audit and performance review

3.66. Given the clear responsibility and accountability of the head of each department/authority to achieve an adequate level of performance against objectives in terms of effectiveness, efficiency and economy, and to ensure adherence to prescribed financial and other regulations of government, the relevance of and need for some form of internal performance review mechanism has been recognised by most authorities and this issue Will be examined in the rest of the report.

3.67. In N.S.W. performance review mechanisms takes several forms, including:-

(a) internal audit units, which may be restricted to reviewing financial regularity and compliance, or may be extended to provide reviews of effectiveness, efficiency and economy; for reasons of independence these audit units do not usually assist in implementing improvements;

(b) internal inspectorates, O & M units, management consulting groups, etc., usually concentrating on reviews of the effectiveness, efficiency and economy of systems and organisations and in many cases assisting management in implementing improvements.

3.68. The essential feature of these internal review mechanisms is that they are a service to management. They provide assurance to management that the internal control and management information systems that have been put in place are adequate and working and give early warning of any breakdowns in control. They are not substitutes for sound management planning and decision - making, but rather provide added safeguards to management accountability.



## 4 ROLE AND SCOPE OF INTERNAL AUDIT & PERFORMANCE REVIEW

### TERMINOLOGY

4.1. There is a variety of terminology used to describe performance review and audit approaches and concepts. The Committee found a number of terms being used differently by witnesses and this confusion over terminology has obviously given rise to some of the current debate on the subject.

4.2. The Committee has considered a number of definitions and has adopted, for the purpose of this report, those definitions which it considers most fairly describe the following terms:-

- \* internal control;
- \* internal audit
  - financial and compliance audit;
  - efficiency and economy audit or review;
  - effectiveness audit or review;
- \* program (or policy) evaluation.

#### (I) Internal control

4.3. Internal control comprises all of the co-ordinate methods and measures adopted within an organisation to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly broader than the meaning sometimes attributed to the term. It recognises that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments (AICPA Auditing Standards).

## (II) Internal audit

4.4. The Committee accepts the definition of internal audit as defined by the Comptroller-General of Canada as:-

"... the systematic, independent review and appraisal of all departmental operations, including administrative activities, for purposes of advising management as to the efficiency, economy and effectiveness of the internal management practices and controls."

4.5. Traditionally, internal auditing in the public sector was confined mainly to an examination of the propriety and compliance with regulations of financial transactions and the security of public monies and other assets. In recent years, the role of internal audit has expanded with more emphasis being placed on the economy, efficiency and effectiveness with which public resources are being used.

4.6. Internal audit developments regarding the scope of audit in the public sector both in Australia and overseas have led to a recognition of three possible levels within a total or "comprehensive" audit. Opinion varies as to whether all three levels should properly be carried out by internal audit units or whether other performance review or consultancy units should be responsible, particularly in relation to effectiveness reviews.

4.7. A paper entitled "Comprehensive Management Audit of Departments", endorsed by the Premier and the Treasurer and circulated to Departments in August, 1984, defined these three levels of the comprehensive audit. The Committee has adopted the following definitions derived from the General Accounting Office of the U.S.A. which are essentially the same as those provided by the paper but are slightly more detailed.

(i) Financial and compliance audit

This determines :-

- (a) whether financial operations are properly conducted;
- (b) whether the financial reports of an audited entity are presented fairly;
- (c) whether the entity has complied with applicable laws and regulations;
- (d) whether assets are safeguarded and liabilities recognised.

Synonyms

Within broad limits the following are considered to equate with "financial and compliance audit":-

- attest audit;
- regularity audit;
- procedural audit;
- security audit.

(ii) Efficiency and economy audit or review

Efficiency refers to the relationship between goods or services produced (outputs) and the resources used to produce them (inputs). Economy refers to the terms and conditions under which the government acquires financial, human and physical resources (inputs).

An efficiency audit or review determines whether the organisation is managing or utilising its resources (personnel, property, space, and so forth) in a relatively efficient and economical manner and the causes

of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organisational structure.

#### Synonyms

Within broad limits the following are considered to equate with "efficiency audit" or "efficiency review":-

management audit;  
operational audit.

#### (iii) Effectiveness audit or review

An effectiveness audit or review determines whether the intended goals or results (outputs) of programs are achieved, whether the objectives established by the legislature or other authorising body are being met.

#### Synonyms

Within broad limits the following are considered to equate with "effectiveness audit" or "effectiveness review":-

results audit;  
program audit.

#### (III) Program or (policy) evaluation

4.8. There is no agreement in the literature of what program evaluation should entail. The terminology used varies widely and is itself the cause of much confusion. Simply stated, program evaluation is the formal assessment of the continued relevance and of the effectiveness of existing programs. That is, it involves the systematic gathering of verifiable information on a program and demonstrable evidence of its results. The Office of the Comptroller General of Canada, in discussing program evaluation, has expanded on this:-



"Program evaluation is the periodic, independent and objective review and assessment of a program to determine in light of present circumstances, the adequacy of its objectives, its design and its results, both intended and unintended. Evaluations will call into question the very existence of the program. Matters such as the rationale for the program, its impact on the public, and its cost effectiveness as compared with alternative means of program delivery, are reviewed."

4.9. In this context a program is a group of government activities, powers or functions that can be related in a logical fashion to a given objective or set of objectives. A program evaluation goes beyond reviewing the effectiveness or performance against stated objectives, and questions the very existence and need for the program. It is concerned with evaluating government policy and assessing its relevance to public needs.

4.10. The recently established Program Evaluation Unit at the Public Service Board has defined program evaluation thus:-

- \* collecting data on the reasons for the choice of a program;
- \* collecting data on the results achieved in relation to those stated in the objectives of the program;
- \* collecting data on factors most likely to effect the achievement of results.
- \* making a judgement from the available data about a cause-effect relationship between the program inputs and activities and the program results.

4.11. In most jurisdictions, a comprehensive audit does not include program evaluation. At the federal level in Canada, for instance, internal audit units undertake financial and compliance audits and 'efficiency and effectiveness audits but program evaluation is undertaken by separate program evaluation units. However, in N.S.W. "program evaluation" seems to comprise both the high level review of the adequacy of programs and objectives, as well as determining to what extent objectives are achieved (effectiveness audit) and whether objectives are achieved at least cost (efficiency audit).

#### (IV) Systematic VS Ad Hoc Reviews

4.12. Based on the evidence presented to the Inquiry and experience in other jurisdictions in Australia and other countries, the Committee also recognises two distinct categories of internal review function:-

- (1) the regular, systematic and independent examination of either
  - (i) internal management controls and reporting systems (internal audit or management audit)
  - (ii) programmes (programme evaluation as defined above in the Canadian sense);to provide a comprehensive level of assurance that management's responsibilities are being discharged adequately;
- (2) ad hoc investigations or consultancy studies designed to diagnose and recommend solutions to specific management problems.

4.13. It is the first category of systematic internal reviews that the Committee is concerned to examine.

## PRESENT STATUS OF INTERNAL AUDIT IN N.S.W.

4.14. Of the organisations covered by the questionnaire 34 (79%) reported the existence of an Internal Audit section by January 1985 (32 in 1983). Over half of the organisations identified the existence of separate units reviewing efficiency and effectiveness. However, further investigation indicated that these units were either working on an ad hoc basis conducting one off special tasks or involved in implementing organisational and systems improvements, rather than a regular and comprehensive program of reviews.

4.15. From the results of the questionnaire and from the public hearings and submissions received from interested parties, it was evident that the current function of internal audit is mainly directed to financial and compliance auditing. Internal audit units to date have had little involvement in efficiency and effectiveness auditing.

4.16. The results of the original questionnaire indicated that approximately 78% of total internal audit time is currently directed to the financial and compliance audit area. The results did not change significantly between the times of circulation of the original Public Accounts Committee questionnaire and the follow up questionnaire in January 1985. This survey result is also supported by The Institute of Internal Auditors - Australia's survey of all government internal auditors (federal and state) in N.S.W. in November 1983, which indicated that approximately 72% of N.S.W. Government internal audit time was directed to financial and compliance auditing. This can be compared with approximately 30% of total audit time devoted to financial and compliance audits in Commonwealth Government departments and authorities situated in N.S.W.

4.17. Thus, on average, only 22% of N.S.W. government internal audit time is spent on the assessment of efficiency and effectiveness.

4.18. The Inquiry revealed that managers in N.S.W. government tended historically to see the internal audit role as being to ensure compliance with procedures and regulations. As we shall examine, this perception is retained in some quarters while a broader role is recognised by others.

4.19. The Committee concluded that the status generally in N.S.W. public authorities, prior to the full impact of the enactment of the Public Finance & Audit Act, 1983, was that, with some exceptions, internal audit and review activities lacked clear objectives and direction within authorities as to their scope and role.

4.20. However, it is evident that changes have been undertaken to react to the requirements of the new legislation. Such improvement is coming about both as a result of individual heads of departments or authorities acting on their own initiative, and through some guidance from the central agencies of government, to be examined later. It is clear to the Committee though, that much remains to be done.

#### Issues and recommendations

4.21. In carrying out this Inquiry it was clear that opinions on the role, scope and organisation of internal audit and performance review within the public sector differed significantly from one authority to another and among the central agencies, Auditor-General's office and other interested parties. This difference of opinion is still not resolved with the enactment of the Public Finance & Audit Act, 1983, which states that :-

II. (1) The head of an authority shall ensure that there is an effective system of internal control over the financial and related operations of the authority, including:-

(a) management policies and requirements made by the provisions of this Act and the prescribed requirements;

- (b) sound practices for the efficient, effective and economical management of functions by each organisational branch or section within the authority;
- (c) a system of authorisation and recording and procedures adequate to provide accounting control in relation to assets, liabilities, receipts and expenses;
- (d) proper segregation of functional responsibilities; and
- (e) procedures to review the adequacy of and compliance with the system of internal control.

{2} Wherever practicable, the head of an authority shall establish and maintain an effective internal audit organisation which shall be responsible to the head of an authority for:

- (a) the regular appraisal of the adequacy of and compliance with the system of internal control;
- (b) the review of operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned; and
- (c) the reporting directly at regular intervals to the head of the authority as to the result of any appraisal, inspection, investigation, examination or review made by the internal audit organisation.

4.22. While the Public Finance & Audit Act legislation has sought to clarify the responsibilities of management, it has left two questions on the role and scope of internal audit open to debate:-

(I) by requiring that the head "wherever practicable, shall establish and maintain an effective internal audit organisation" the question arises of what discretion is implied by the words "wherever practicable" i.e. to what extent is it mandatory to have an internal audit organisation?

(II) if the organisation has an internal audit organisation, must it include the three functions of: financial/compliance; efficiency/economy; and effectiveness auditing.

4.23. Is an internal audit organisation mandatory?

Although the inquiry revealed a consensus that heads of authorities were responsible for the efficiency, effectiveness and internal control of their organisations, there was little agreement about the extent to which S.11 of the Public Finance & Audit Act required the establishment of an internal audit unit.

4.24. The paper entitled "Comprehensive Management Audit of Departments", endorsed by the Premier and the Treasurer in August 1984 stated:-

"The Public Finance & Audit Act requires the Head of a Department to establish and maintain an effective internal audit organisation and its functions could include a review of the operation of programs."

4.25. Thus, although the legislation states that "wherever practicable" an internal audit organisation be established, this authoritative document regards such an organisation as a requirement. Indeed, this interpretation is shared by the N.S.W. Auditor-General, Mr. Jack O'Donnell who said in evidence before the Committee:

"Section 11 requires the head of an authority to establish and maintain an effective internal audit organisation responsible to that authority's head. I observe that that requirement is to be met wherever practicable. This seems to make it optional.

Actually it merely allows flexibility of method. The head of an authority cannot shed the responsibility for performance of the authority's functions. Any head of authority who opts out of having an internal audit organisation, or who does not allow internal audit to have direct access, is at serious risk of being caught unaware of deficiencies in performance lower down the operational area."

4.26. However, the Chairman of the Public Service Board stated that "I venture to suggest that I have no responsibility under Section 11 (2) of the Public Finance and Audit Act", recognising above all the optional nature of the need to establish an internal audit organisation.

4.27. In examining this issue, the Committee recognises that the head of a department or authority is specifically charged with maintaining an effective system of internal control over the financial and related operations of the authority. In addition, the head is also charged with the responsibility, wherever practicable, to maintain an effective internal audit organisation.

4.28. In the Committee's view, internal audit forms part of management's overall system of internal control, regardless of the statutory requirement to maintain an internal audit organisation.

4.29. In assessing the relevance of internal audit in the management of the public service, the Committee recognises that a particular type or level of internal performance audit mechanism cannot be regarded as mandatory. To make it so would be to compromise the responsibility of management. It is arguable that the phrase "wherever practicable" in the Public Finance and Audit Act, permits that the head of an authority could rightly decide, in the interests of economy, not to maintain an internal audit or other internal performance review function, provided he/she was satisfied and could demonstrate to any external review function that there existed:-

- (a) a sound structure of objectives, organisation, management delegation and resources;
- (b) an effective and comprehensive system of internal controls;
- (c) adequate management information reporting systems to enable performance to be measured and monitored on a timely basis for decision making before adverse trends become material.

4.30. Whatever the choices made by the heads of authorities, the legislation makes clear that the consequences of failure of the system are their direct responsibility.

4.31. The Committee considers that the ideal management system is extremely unlikely to be achieved on a consistent basis over time, and that authorities should be required to maintain internal audit functions, to provide added assurance that major weaknesses have not developed, and to recommend ways of improving performance. This assurance is given because of the nature of internal audit - "a systematic, independent review and appraisal of all organisational operations".

4.32. In the Committee's opinion, the legislation should make clear that the performance of the functions as outlined in Section 11 (2) are compulsory, although the organisational form of these functions should be left to the discretion of management. Thus the Committee recommends

That Section 11 (2) of the Public Finance and Audit Act be redrafted to clarify that the head of an authority is responsible for ensuring the performance of the functions outlined in the legislation but that the organisational form of the internal audit function be left to the discretion of management.

4.33. That the Committee commends the establishment by departments/ authorities of separate internal audit units.



4.34. At the same time, the Committee cautions authorities against relying on internal audit and performance review functions as a substitute for sound management and adequate internal control systems. The establishment of an internal audit function, or other review mechanism, will not, by itself, discharge management's responsibility for achieving adequate performance against its objectives.

4.35. The issue of how heads of small organisations can fulfill their obligations under the Public Finance and Audit Act is considered under the section on organisation.

4.36. Must internal audit cover efficiency and effectiveness?

A second issue which has arisen from the legislation is whether an internal audit organisation, if it exists, must necessarily review efficiency and effectiveness, as well as financial and compliance.

4.37. As examined, the Comprehensive Management Audit paper stated that the functions of the internal audit organisation "could include a review of the operation of programs". It also stated:

"The primary responsibility for management efficiency rests with the Department which must set up satisfactory mechanisms and procedures for internal auditing of finance, economy and efficiency and evaluation of programs.

Departments should consider establishing a Managing Audit Branch with responsibilities for auditing all aspects of management. In the larger Departments separate branches for financial audits and efficiency and effectiveness type audits might be more appropriate."

4.38. It is clear that the Comprehensive Management Audit paper did not consider it necessary that an organisation entitled "internal audit" be responsible for examining finance and compliance and efficiency and effectiveness, nor that a single organisation, however

entitled, have this scope of review. That is, as long as these functions are adequately fulfilled, there is a reluctance to prescribe to management precisely how they should be organised. However, different witnesses at the public hearings had varying views about the capacity and desirability of internal audit fulfilling an expanded role.

4.39. The heads of the Treasury and the Public Service Board favoured restricting the role of internal audit to financial and compliance issues.

#### Treasury

The Secretary of Treasury stated, "I, personally, have some reservation as to whether internal audit, formed under the Public Finance and Audit Act, could or should embrace a much wider range of responsibilities that fall under evaluational performance reviews".

#### Public Service Board

In answer to a question whether internal audit should conduct efficiency and effectiveness reviews, the Chairman of the Public Service Board stated:

"I do not think so. We are working at a somewhat higher level of abstraction than what is normally conceived as an internal audit."

Mr. Moore added that in ordinary legal construction many lawyers view S.11 of the Public Finance and Audit Act as referring to financial matters only and not to wider management matters.

## Premier's Department

However, the Secretary of the Premier's Department considered that there were advantages in having one internal audit unit responsible for reviewing financial compliance, efficiency and effectiveness.

He said :

"In my own department the internal audit group will be responsible for efficiency and economy reviews. I have not yet determined the extent to which that group will be responsible for reviewing the effectiveness of the programmes, but my inclination is that that will be the same group that will do the job. I see it as quite embracing. So far as the internal group within the department is concerned, I do not think one can have clear distinctions between efficiency and effectiveness. When all is said and done, what I have been saying for years is that efficiency reviews embrace the concept of effectiveness. It is simply that over the past ten years we are all starting to get our definitions clearer."

## Auditor-General

The Auditor-General viewed S.11 of the Public Finance and Audit Act as extending internal audit beyond the traditional review of financial propriety to questions of efficiency and effectiveness, particularly in view of S.11 (2) (b) of the legislation. He went on to say that the whole thrust of S.11 was performance related and designed to assist the head of the authority to perform and to provide controls that will improve performance.

The Senior Vice President of the Institute stated that the Institute regarded the head of the authorities under S.11 of the Public Finance and Audit Act as having responsibility to ensure that the internal audit section covers financial auditing and efficiency and effectiveness reviews.

4.40. The N.S.W. Treasurer issued, on 1st May, 1984, guidelines for internal audit of financial and related operations covering financial/compliance auditing only. In those guidelines, the Treasurer confirms that "the Treasury views an effective internal audit function as essential for the maintenance of efficiency and economy, as well as providing a basis for the review of internal financial and related operations and internal control systems of departments and authorities". The Treasury further recognises that heads of departments and authorities may wish to use internal audit in a wider range of tasks than examining the financial and related operations, and that the scope of the audit function will be determined by them in the light of management needs.

4.41. The arguments in favour of combining these functions are to ensure proper planning and co-ordination of the coverage of reviews, and to avoid duplication and overlap. Mr. B. Leithhead, Senior Vice-President, Institute of Internal Auditors, Sydney Chapter, in testimony to the Committee, said:-

"One of the major concerns that my Institute has is that internal auditing in the New South Wales Government may become fragmented into separate functions seriously limiting its effectiveness. This will develop if a proper understanding of internal audit scope is not achieved. There is a developing recognition for different areas of internal audit involvement; for example financial and compliance, efficiency and economy, and program effectiveness.

The nature and scope of internal auditing in government has evolved rapidly in recent years in a number of parts of the world."

4.42. In a supplementary submission to the Inquiry, the Institute noted that the following advantages would ensue from combining the three functions:

- a broad scoped review function
  
- a multi,disciplinary staff composition
  
- comprehensive reporting to management

4.43. The arguments against combining these functions relate to the different skills required and the different emphasis.

4.44. The Secretary of the Treasury, Mr. N. Oakes, in response to the question:-

"Would there be any advantage in having only one unit within the organisation devoted to reviewing this performance?"

replied,:

"I believe that the requirements to carry out a true performance evaluation would call for qualifications that may not necessarily reside in the staff of the internal audit unit."

When asked:-

"If such a unit would review financial and compliance issues, as well as efficiency and effectiveness, but not be called internal audit, do you think such a unit would be more successful than if it were called internal audit?"

Mr. Oakes responded:-

"That is a subjective judgement that you would have to form. Internal audit, and the word audit itself, has a particular connotation in the financial sense. The type of audit that is embraced by the term effectiveness reviews or evaluation, is quite a different form of audit."

4.45. The Committee notes that S.11 (2) (b) of the Public Finance and Audit Act appears to prescribe that where there is an "internal audit organisation", it shall be responsible for effectiveness, i.e. for reviewing operations to ascertain whether results are consistent with objectives. However, the setting up of the internal audit organisation is discretionary, to be done "wherever practicable" and in the Committee's view this spirit of discretion prevents any prescription of scope for the audit organisation's role. The Committee concludes therefore that the manner in which the various levels of comprehensive audit coverage be organised is at the discretion of management.

4.46. However, the Committee considers that there are significant advantages in giving the audit function the scope to cover the regular review of the whole internal management control and reporting system. As defined earlier in the report, the three levels of comprehensive audit include controls over financial propriety and compliance with regulations, efficiency and economy in the use of resources and effectiveness in achieving objectives. All of these management controls are, in the opinion of the Committee, clearly and necessarily interrelated. The emphasis in internal audit developments in many jurisdictions in Australia and overseas (see Appendix C) in recent years, has been to integrate the auditing of these management controls. Methods and skills are becoming established and standardised for conducting these types of comprehensive audit.

4.47. The Committee recommends:

That heads of departments/authorities be coordinated to internal audit covering the three levels of comprehensive audit coverage - financial and compliance, efficiency and economy in the use of resources and effectiveness in achieving objectives.

4.48. The Committee considers that when the audit function is expanded to include efficiency and effectiveness, the term "management audit" may usefully be applied to the function. This would remove the narrow connotation traditionally attributed to "internal audit". In addition, it would stress the group's role as a service to management.

4.49. The question arose during the inquiry of whether audit should also undertake the ad hoc, consultative type of review defined earlier. This involves a much more diverse range of objectives, methods and skills, depending on the nature of the problem addressed. While reviews of this type have an important place in the management of many organisations, they serve a different purpose from audit, and are probably better organised and staffed separately from the audit function. Separation of this function also has the advantage of avoiding any dissipation of the regular programme of audit, which can arise from the unpredictable resource demands resulting from urgent ad hoc investigation requests. In addition, audit will not be in the position of auditing the recommendations it has itself made, but will be independent from the problem, solving consultancy group.

4.50. The question arose during the inquiry of whether internal audit should also perform program evaluation, that is, effectiveness evaluations that extend to questioning the nature and rationale of the program itself. In Canada, this function is performed separately in each organisation by a program evaluation unit.

4.51. Program evaluation is in its infancy in N.S.W. The Program Evaluation Unit at the Public Service Board has been established to advise senior and line management and evaluators about program evaluation which includes efficiency and effectiveness reviews. There

is no expectation that separate program evaluation units will be established within organisations, but this function is seen as a role of management.

4.52. Although there do seem to be advantages in having a periodic, independent and objective review of all programs by a separate unit, at this stage, the Committee is unwilling to recommend further structures of review. Indeed, in Canada there is a recognised overlap between the program evaluation and internal audit functions. The Canadian Government's "Guide on the Program Evaluation Function" states:

"There can be an overlap between the two functions, especially on matters concerning the outputs of the program and it may not always be possible or desirable to draw a line between them. This will tend to be the case, for example, with many administrative support functions and programs which are procedural or repetitive in nature, producing a well-specified good or service. When in such cases the program has little direct impact on society, or its operations are mandated by law, a well-developed internal audit function may, in some departments, address most of the issues for that program that would normally be part of a program evaluation, such as level and quality of service issues. That is, internal audit would consider all questions which were appropriate to it and in some cases these would cover many of the "evaluation" questions sensibly asked of the program. However, internal audit would not normally cover the evaluation questions of alternative delivery mechanisms and, of course, any question as to the continued existence of the program."

4.53. The Committee considers that the future-oriented questions about the continued existence of the program or alternative delivery mechanisms may be considered part of the policy and planning function of management. The Comprehensive Management Audit paper envisages that at this stage a few major programs will be evaluated internally each



year. The Committee supports this expectation but believes that in accordance with the Public Finance and Audit Act, S.11 2 (b), this review should be extended to provide a regular review of all programs.

4.54. To the extent that there is a need for an independent review of the rationale and continued existence of the program, this function should continue to be served by management strategy reviews at the Premier's Department.



## 5 CENTRAL AGENCY INVOLVEMENT IN INTERNAL REVIEWS

### Present Status

5.1. There is little co-ordination at the central agency level in advising departments and authorities on internal audit and review. However, the Public Service Board's Efficiency Audit Division has produced an "Index to Successful Review Mechanisms" which provides organisations with an understanding of what reviews exist and the contact people for each review.

5.2. The fragmented nature of central agency involvement is examined below:

### Financial and Compliance issues

5.3. Responsibility for providing guidance and services relating to the traditional financial and compliance role of audit has been accorded to the Treasury. In May, 1984 it issued guidelines covering only the financial and compliance role of internal audit. There was some concern at the time that these guidelines limited the role of internal audit to this narrow and traditional function. However, the introduction to the guidelines explicitly recognised that Heads of Departments and Authorities might wish to use internal audit in "a wider range of tasks" than examining financial and related operations.

5.4. The Treasury has also set up an Internal Audit Bureau which will initially undertake audits of a financial and compliance nature for "smaller departments or statutory authorities which could not justify a full-time internal audit staff or could not for one constraint or another obtain internal audit staff of a sufficient calibre" (Treasury submission). Out of a survey of 52 organisations, fifteen indicated that they would use such a service. The Bureau will charge fees of its clients and will report directly to the head of the client organisation and not to the head of Treasury on the results of individual audits.

As clients must be assured of the confidentiality of their audit results, the position of the Internal Audit Bureau in Treasury must be seen to be strictly independent.

5.5. The Committee understands that the Internal Audit Bureau's services will in the future extend to efficiency and effectiveness audits and urges that this evolution be given serious attention and be accomplished expeditiously.

#### Efficiency and Effectiveness

5.6. The Public Service Board's Efficiency Audit Division has produced a Manual on Efficiency Auditing to inform auditors and reviewers of how to conduct efficiency audits. The Efficiency Audit Division also serves a training function in exposing public servants to the techniques and approaches of efficiency audits.

5.7. As part of its role in advising on program evaluation, the Program Evaluation Unit will advise on techniques efficiency and effectiveness review and provide guidelines to assist organisations in evaluating the efficiency and effectiveness of their programmes. Although this advice will be available to auditors/reviewers, it is not designed specifically for them but will also be available to senior and line management.

#### Program Evaluation

5.8. As we have examined in Section III, "program evaluation" in N.S.W. comprises not only a high level review of the adequacy of objectives and programs but also what we have termed efficiency and effectiveness reviews of programs.

5.9. The Program Budget Steering Committee composed of the heads of the Premier's Department, the Public Service Board, Treasury and Senior Policy Advisers was established by the Treasurer in 1983 to oversee the introduction of program budgeting. The Committee recommended the establishment of the Program Evaluation Advisory Committee to assist heads of organisations in the introduction and development of program

evaluation. The Committee is comprised of senior officers from the Public Service Board, Premier's Department, Treasury and the Senior Policy Advisor to the Treasurer and is serviced by the Program Evaluation Unit of the Public Service Board.

5.10. As stipulated in a memorandum from the Premier to all Ministers on 20 March, 1985

"The role of the Programme Evaluation Committee is to:

- lay down standards and guidelines to assist departments in evaluating the efficiency and effectiveness of their programmes
- provide training in programme evaluation for department heads and staff and
- monitor the reporting by departments of effective 5 year plans for their programme reviews."

5.11. The Program Evaluation Unit has an advisory role in developing program evaluation in the public sector. Initially, the unit will provide training for senior and middle managers on program evaluation techniques. At the same time it will develop standards and guidelines on program evaluation and provide advice about specific evaluation problems.

5.12. In addition, in exceptional circumstances, the Premier might request the Public Service Board to carry out a program evaluation review in cases where a department does not have the necessary skills or where an internal review is considered deficient.

5.13. The paper entitled "Comprehensive Management Audit of Departments" suggested that each year a few programs be evaluated and the results published in the organisation's annual report. Reports on the evaluation of programs are to be monitored by the Premier's Department and the Treasury.

## Conclusions and Recommendations

5.14. The Committee concluded that there is little clear, unified direction from the central agencies about the development of comprehensive audit and review in N.S.W. departments and organisations. Although valuable services exist, such as those provided by the Efficiency Audit Division and the Program Evaluation Unit at the Public Service Board, these are not specifically directed at guiding and training internal auditors and reviewers.

5.15. The Committee is concerned that the fragmentation of services at the central agency level may well lead to the fragmentation of the audit/review function at the organisation level.

5.16. As examined, Treasury has responsibility for providing guidance and services relating to the traditional financial and compliance role of audit .

5.17. It may be argued that there is some co-ordination in the provision of advice about the three levels of comprehensive audit covered at the central agency level in that the Program Evaluation Advisory Committee contains senior representatives from Treasury. However, the role of this Committee and of the Program Evaluation Unit is not to advise specifically on efficiency and effectiveness audit but on program evaluation. Although there is certainly an overlap in that both efficiency and effectiveness audit and program evaluation consider the evaluation of efficiency and effectiveness, they are not identical functions.

5.18. First, program evaluation is broader in considering the very adequacy of the program itself.

5.19. Second, program evaluation is primarily the responsibility of management and managers must ensure that they have clear, measurable program objectives and devise the means of evaluating the attainment of these objectives. Auditors then may perform an efficiency and effectiveness audit of these programs.

5.20. To provide Treasury guidance on financial/compliance matters and a central unit to advise on program evaluation, is not to meet or recognise the specific needs of those engaged in comprehensive auditing.

5.21. Further, this division at the central agency level may lead to the perception that audit should be confined to financial and compliance matters and that efficiency and effectiveness questions should be considered by management alone or by another unit. This perception would inhibit the expansion of the role of internal audit to cover financial/compliance, efficiency and effectiveness.

5.22. The Committee is therefore concerned that a unit be established at the central agency level to provide direction, guidelines and training regarding all levels of comprehensive auditing. In the Commonwealth, this coordinating and guiding role is performed by an interdepartmental committee serviced by a unit in the Public Service Board.

5.23. We understand that the N.S.W. Public Service Board is presently re-examining its role, structure and function and consider that the Public Service Board is the appropriate agency to provide guidance about comprehensive auditing.

The Committee therefore recommends:

5.24. That a unit be established within the Public Service Board to provide direction, guidelines and training regarding all levels of comprehensive auditing. This unit might be entitled The Management Audit Advisory Unit.

5.25. That the services offered by this unit include:

- advice about how to establish audit units, whether they be devoted to financial and compliance matters or be involved in all three levels of comprehensive audit coverage;

- advice about the preparation of audit policies and plans;
- advice about the staffing of senior positions;
- advice about audit methodology;
- provision of guidelines about financial and compliance audit (this responsibility should be taken from Treasury) and guidelines about efficiency and effectiveness auditing;
- delivery and design of audit training where needed and provision of advice about relevant training and courses available;
- education of senior management about the benefits of comprehensive audit;

5.26. That the unit also conduct regular, formal, quality assurance reviews of internal audit/management audit units and recommend improvements to the heads of departments/authorities.

5.27. That the Internal Audit Bureau presently with Treasury be attached to this unit/division.

5.28. An advantage of having the Internal Audit Bureau part of the Public Service Board is the stimulus this will give to expanding its service from financial/compliance audits to efficiency and effectiveness audits.

5.29. The Committee considers that an interdepartmental committee might be established to provide coordination and overview of the activities of the Management Audit Advisory Unit. The interdepartmental committee should include representatives from the Auditor-General's Office, Treasury, Public Service Board, Premier's Department and a small number of operating departments/authorities.



5.30. The Committee recognises the existence of the Program Evaluation Advisory Committee and suggests that consideration be given to expanding the membership and role of this Committee to fulfill this need as an alternative to creating another committee.



6 THE RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL REVIEWS

6.1. The Committee's questionnaire revealed that heads of departments and authorities relied heavily on external reviews by external consultants, the Public Service Board, Premier's Department and the Auditor-General to assess whether or not their organisations were functioning as they should.

6.2. It is clear that an important role will continue to be served by external reviews. As the table below indicates, each review serves a different function in reporting to different levels of the political system.

Table of management, responsibility and review  
within New South Wales

Review function	Responsible to
Auditor-General Public Accounts Committee	Parliament
Public Service Board - Efficiency Audit Division Premier's Dept. - Management Strategy Review Program	Government
Internal audit function Management services units	Departments

6.3. External reviews from the central agencies of government, such as efficiency audits from the Public Service Board and management strategy reviews from the Premier's Department, report to the government, that is, to Ministers.

6.4. External reviews on the operations of authorities from such parliamentary review bodies as the Auditor-General, the Ombudsman and the Public Accounts Committee obviously report directly to Parliament. It is not the intention of the Committee in this report to comment on the adequacy of external reviews, either in terms of their scope or their implementation.

6.5. External reviews will of course continue to be necessary, but the new emphasis on internal audit, a form of review which reports directly to management and not to government or to Parliament, will necessarily increase the involvement of heads of authorities in reviewing their own performance.

6.6. The role of external reviews arose frequently in the course of this Inquiry, and we would like briefly to outline the role of each external review, before considering the relationship between internal and external reviews.

## EXTERNAL REVIEWS

### Parliamentary Reviews

6.7. The distinctive feature of Parliamentary reviews by the Auditor-General and the Public Accounts Committee is that they report to the Parliament and the public. Thus, unlike reviews undertaken by the central agencies, the reports of the Auditor-General and the Public Accounts Committee are public documents. These reports thus serve a very different role from those to be used by management alone - an essential role of public accountability. Without such reports, the public would have little idea of the operations of government organisations - other than what the organisation itself chose to divulge.

(a) The Public Accounts Committee

6.8. The role of the Public Accounts Committee generally is to serve as a Parliamentary watchdog of government expenditure to ensure that government organisations are implementing government policy as efficiently and effectively as possible.

6.9. Not only are the reports public, but through public hearings the Committee aims to ensure that its activities are as open as possible effectively to gather information and to encourage participation and consultation.

6.10. In pursuing its functions under S.57 of the Public Finance and Audit Act, 1983, the Public Accounts Committee has undertaken both wide-ranging reviews covering many statutory authorities or departments and single issue inquiries relating to one organisation.

6.11. Under S.57 of the Public Finance and Audit Act 1983, the Public Accounts Committee is charged with the following functions:

examining the Public Accounts;

examining the accounts of statutory authorities;

examining the Auditor-General's Report and related documents;

reporting to the Legislative Assembly from time to time upon any item in or any circumstances connected with the above accounts, reports or documents;

reporting to the Legislative Assembly at the Committee's discretion upon any alteration considered desirable in the form of the accounts, the method of keeping them or the method of receipt, expenditure or control of money;

inquiring into and reporting to the Assembly on questions relating to the accounts referred to it by the Legislative Assembly, a Minister or the Auditor-General;

·           inquiring into and reporting on any over expenditure by Ministers.

6.12. The Committee is precluded by the Public Finance and Audit Act 1983 from inquiring into government policy.

6.13. The powers of the Committee became an issue in the course of this Inquiry. Ultimately the power of the Public Accounts Committee to examine issues of efficiency and effectiveness was confirmed by the Crown Solicitor.

(b)       Auditor-General

6.14. The Auditor-General's appearance before this Inquiry was of some historical importance in being the first attendance by an Auditor-General before a Public Accounts Committee public hearing in N.S.W. It is somewhat ironic, therefore, that this Inquiry also gave rise to a public challenge to the Auditor-General's powers.

6.15. Under the Public Finance and Audit Act the Auditor-General has wide powers to audit the accounts "in such manner as the Auditor-General thinks fit having regard to the character and effectiveness of the relevant internal control and recognised professional standards and practices" and report to Ministers and Department Heads on the result of an audit and "as to such irregularities or other matters as in the judgement of the Auditor-General call for special notice". Section 52 states unequivocally that the Auditor-General may generally report on any matter arising from audit which in the opinion of the Auditor-General should be brought to the attention of Parliament.

6.16. The Committee 'considers that the Auditor-General has in no way attempted to exceed his powers and would like to confirm the Auditor-General's freedom to audit and report as provided for in the Public Finance and Audit Act.

#### External Reviews by Central Agencies

##### (a) Management Strategy Reviews by the Premier's Department

The Premier's Department conducts wide ranging external reviews evaluating the "effectiveness of organisational structures and managerial strategies in producing outputs that fulfil stated policy objectives". {Comprehensive Management Audit paper) These high level effectiveness reviews are strongly policy oriented, extending to questioning the need for the organisation itself. The organisations to be reviewed are chosen by the Premier and the reviews are carried out by private consultants. Management strategy reviews are highly secret documents, with initial access restricted to the Minister and the head of the organisation.

##### (b) Efficiency Audits by the Public Service Board

The Public Service Board conducts external efficiency audits of departments and authorities pursuant to S.4 {1) and S.105 of the Public Service Act. "Such audits are concerned with the efficiency of existing managerial practices and operational systems in using inputs to derive outputs" {Comprehensive Management Audit paper). As with management strategy reviews, these audits are approved by the Premier and the reports are extremely restricted in circulation, copies initially being given to the Minister and to the head of the organisation.

Given the Committee's preference for openness in government generally, it questions the necessity of treating these reports with such secrecy. It is argued by those in favour of restricting access, that the authors of the report would be less frank and hardhitting if the documents were public, and the reviews therefore less useful. However, there is an equally strong argument that public scrutiny will promote constructive action, and act as a stimulus to improved performance.

The Committee recommends that efficiency audit reports and management strategy reviews be tabled in Parliament within eighteen months of their presentation to the Minister along with the organisation's response and program of action.

6.17. As one of the prime objectives of this review is to consider efficiency and effectiveness within the public sector, it is important to ensure that any internal audit or performance review and improvement mechanism established is set up in such a way as to avoid duplication of effort and overlapping of responsibilities, wherever possible. It is therefore necessary to consider briefly the relationship between the internal audit function of a department or authority and the external auditors and other external review assignments.

6.18. At present, there does not appear to be a great deal of overlapping of effort, as internal audit is not involved heavily in efficiency and effectiveness reviews, although other internal review units (inspectorates, management services units) do some efficiency review work. With regard to financial and compliance auditing, the Auditor-General does take into consideration the work by internal audit at the various departments and authorities for which he has audit responsibility.

6.19. In his testimony before the public hearings, the Auditor-General referred to the relationship between internal audit and external audit as "firstly supportive, certainly complementary, and, most importantly,



no duplication". He indicated that he saw internal audit, properly conducted, as providing management with a vital early warning system which could not necessarily be expected from an external audit conducted only once or twice a year. To ensure efficiency in the audit approach, the Auditor-General indicated that the external auditor necessarily takes account of the work performed by the internal auditor. In this regard, it modifies the extent and depth of coverage by the external auditor and acts as an independent assessment of the effectiveness of internal audit by reviewing such work and reporting back to management.

6.20. The Institute of Internal Auditors - Australia has also addressed the question of the relationship between the internal and external review functions, and summarised the key ingredients of an effective relationship between such functions as involving:-

- co-ordination of the planning of coverage;
- co-operative review processes;
- free information exchanges;
- mutual respect of objectives, talents and approaches of each function.

6.21. The Institute was careful to point out the need for differences in review objectives to be considered when establishing the degree to which co-ordination and co-operation in the conduct of the reviews can be planned.

6.22. It is important therefore to ensure that any external review is conscious of, and takes into consideration, the degree of internal control and review established by the head of department or authority.

6.23. While both internal auditors and the Auditor-General, when requested, supply information to reviews by central agencies, in practice there appears to be little feedback or reciprocity. The

secrecy of these reviews is likely to result in some "re-invention of the wheel" by the other internal and external reviews not privy to the reports of the Premier's Department and the Public Service Board.

6.24. The Committee considers that liaison between internal audit/review and external audit/review mechanisms is essential.

The Committee recommends that:

6.25. The internal audit charter require regular meetings with the external auditors to co-ordinate the extent, scope and timing of internal financial and compliance audit work conducted.

6.26. The internal audit unit liaise with external reviews to ensure their knowledge of the level of internal review performed.

6.27. That where an external review has been conducted, the internal auditor/reviewer should conduct follow up reviews to ensure that the recommendations of the external review are being acted upon.

## 7 ORGANISATION

7.1. The question of whether or not it is desirable to combine all the internal audit and performance review functions into one single organisational unit has been dealt with in the section on role and scope of internal audit and performance reviews, as the issue of role is inseparable from that of organisation. Other organisational matters remain to be considered.

### Present Status

7.2. From the results of the questionnaire circulated by the Committee it was found that 32 authorities had a separate internal audit function, usually headed by a chief internal auditor, reporting to either the department or authority head or another senior member of the management team. Of these, 13 indicated that the internal auditors were used as relief staff in accounting or other operational areas.

7.3. Other performance review functions are usually organised separately from internal audit, sometimes as part of broader management services functions. 28 authorities indicated that they had separate units conducting efficiency reviews.

7.4. It was found that 15 of the departments had an internal audit function comprising 3 members or fewer staff.

7.5. As examined, the need to provide an internal audit resource to the smaller departments and authorities has been considered by Treasury and they have taken action to establish an Internal Audit Bureau. The purpose of this bureau is to employ the necessary resources to provide internal audit services on a "contract" basis to departments or authorities requesting such service. The justification for the bureau evolved from a questionnaire circulated by Treasury to departments and authorities, which indicated that 15 out of 52 organisations would utilise the services of the bureau. We understand that for the present the service to be provided by the Internal Audit Bureau will be limited

to financial and compliance audit only and have urged that these services be extended to cover efficiency and effectiveness auditing as soon as practicable.

Issues and recommendations

Small units

7.6. One issue that arose during the inquiry was whether an internal audit group of one would be effective.

In response to the question :-

"What do you believe would be the minimum effective size for an internal audit unit or other review function?"

the Auditor-General responded:-

"Again, it is like the length of the Chancellor's foot. It can be done sometimes with one person, in a very small organisation, but then a risk exists because of illness or that one person may be lost and there is no continuity of thought. I tend to think, bearing in mind my answer, that if you are down to one person the minimum salary grade is about grade 5 or 6. If you are in that kind of organisation you begin to wonder whether that is the most effective way of doing it. If you can only afford one person it may be better sharing services with another organisation or hiring an accountant through one of the accountancy placement firms, or subcontracting to a firm of accountants. As I understand it, the Treasury is now establishing an internal audit bureau, to provide a pool of people who would be available. If you are down to one person, the organisation should be looking seriously at an alternative way of doing it; of getting, say,

two people in for six months of the year. That may be a better plan than trying to keep one person at a fairly low level of effectiveness."

7.7. The Institute of Internal Auditors - Australia, on the other hand, considers that one staff member could constitute a viable internal audit unit.

7.8. However, the Committee considers it unlikely that a unit of one person would be fully effective or sustainable. Also it is unlikely that one person would have all the qualifications necessary to conduct reviews in the three principal functional areas of internal audit. To employ a suitably experienced and qualified staff member to meet minimum necessary requirements for the position, would require that person also to become involved in detailed audit work. It is considered that most auditors with such qualifications would generally be unwilling to accept such a role. Furthermore, a single auditor is likely to find it professionally stultifying to work in isolation without the stimulation of peer group discussion and exchange. The Committee concludes, therefore, that to obtain the necessary experience and to have appropriate staff to conduct the necessary field work a minimum of two members usually is required to constitute a viable internal audit function and provide the range of skills and professional development required.

7.9. The Committee considers that small departments/authorities which cannot justify a team of 2 internal auditors will probably find it more cost effective to obtain contract internal audit services from the Treasury's Internal Audit Bureau, from private sector professional auditors, or from shared resources with another authority. However, that judgement must remain with the head of authority.

#### Reporting level

7.10. Section II of the Public Finance and Audit Act, 1983 requires that the internal auditor be responsible directly to the head of the department or authority. This is not always the situation currently. In some authorities the internal auditor reports to other levels of

management, and sometimes to the senior financial manager, who is directly responsible for the areas being audited. This is a serious weakness which can give rise to a lack of objectivity in the overall findings of the internal audit unit.

7.11. To be effective in fulfilling the safeguard role, any form of internal performance review needs to be independent of the levels of management being reviewed, otherwise its findings may be compromised along the management line.

7.12. The Committee recommends, therefore, that internal audit report directly to the head of department/authority or at least have right of direct access. Internal audit, in any case, should report to senior management and not to line management, e.g. not to the Financial Comptroller.

#### Independence

7.13. The current practice in a number of authorities of using internal auditors as relief staff in accounting or operational areas represents a serious weakness in the organisational structure of these departments, as the internal auditors then lack independence, which could impair their objectivity, as well as prejudicing the audit programs to be completed with given resources and time.

7.14. The Committee recommends that the internal audit unit should be independent of other activities within the department/authority and should not provide resources as relief staff to other activities.

8 HUMAN RESOURCES

8.1. The Public Accounts Committee's questionnaire results revealed that generally, with some exceptions in the larger departments, internal audit staff were not highly graded and remunerated. There was however some improvement in 1984. In 1983 only 4 internal audit managers were grade 9 or above (making more than \$35,000), while at the time of the follow up questionnaire 9 internal audit managers were so graded.

8.2. The tables below indicate the grades and salary levels of internal audit staff in 1984 and 1983.

	Grade of Internal Audit Staff 1983			
	<u>3 and under</u>	<u>4 to 6</u>	<u>7 to 9</u>	<u>over 9</u>
Grade of Head of Section	1	10	16	4
Number of total staff by grade	67	99	41	8
Average salary	\$16,600	\$24,400	\$30,600	\$37,900
Average years experience	2.15	2.6	6.7	1.9

	Grade of Internal Audit Staff 1984			
	<u>3 and under</u>	<u>4 to 6</u>	<u>7 to 9</u>	<u>over 9</u>
Grade of Head of Section	0	4	13	9
Number of total staff by grade	44	112	54	23
Average salary	\$20,600	\$25,000	\$26,000	\$38,800
Average years experience	3.4	6.5	7.2	13.9

8.3. The problem of grading appears to stem from management's generally low regard for the internal audit function. The problem has been somewhat self-perpetuating in terms of internal audit's involvement in the less traditional audit areas such as efficiency and

effectiveness reviews; management lacks confidence in the ability of internal audit to conduct broader reviews and accordingly does not allocate the resources to upgrade the ability of the function. This conclusion has been supported by the views generally expressed by a number of the witnesses who appeared before the Committee at the public hearings.

8.4. Commensurate with the low grades of internal audit positions, the incumbents of these positions were generally not highly qualified, with only 57% in 1984 having tertiary qualifications. The tables below indicate the qualifications of internal audit staff, according to their grade.

Grading, Experience and Qualifications of Internal Audit Staff, as at  
31st December, 1984

	Grade of Staff									
	3 and under		4 to 6		7 to 9		over 9		Total	
Grade of Head of Section	1		6		15		9		31	
Number of total staff by grade	44		112		54		23		233	
Average salary	\$20,600		\$25,100		\$26,000		\$38,800			
Average years experience	3.4		6.5		7.2		13.9		6.8	
Qualifications:	<u>No</u>	<u>%</u>	<u>No</u>	<u>%</u>	<u>No</u>	<u>%</u>	<u>No</u>	<u>%</u>	<u>No</u>	<u>%</u>
Member of Institute or Society of Accountants	1	3	13	14	18	40	11	55	43	22
Degrees	13	34	31	33	19	42	7	35	70	36
Other qualifications	11	29	35	30	9	18	2	10	57	29
No qualifications	13	34	13	14	-	-	-	-	26	13
Vacancies	38	100%	92	100%	46	100%	20	100%	196	100%
	6		20		8		3		37	
Total	44		112		54		23		233	

8.5. The Institute of Internal Auditors - Australia's submission to the Public Accounts committee, disclosed that from their survey carried out in November 1983, there was no consideration given to the range of qualifications appropriate for a person to be appointed as an internal auditor within the N.S.W. public sector. It further points out that



there has been no attention given by the government to the training or qualifications required to continue as an internal auditor in respect of a department's particular need.

8.6. From the evidence collected during this review we established that there is no formal core training available for internal auditors within the public sector other than voluntary attendance at courses and seminars conducted by the various accounting and auditing professional bodies or other related organisations. However, voluntary attendance at such courses does not appear to be widespread, possibly due to time constraints and resistance to the high cost of course fees.

8.7. While it was not addressed in detail during the review, we did not find any evidence that there was any formal career planning specifically for internal auditors.

#### Issues and recommendations

8.8. The main issue to be considered in this section is the need to define the minimum qualifications and experience for internal auditors within the N.S.W. public sector. In this regard it is necessary to separately consider the qualifications and experience required for:-

- (a) internal audit/performance review unit heads;
- (b) officers responsible for financial and compliance field audit work;
- (c) officers responsible for efficiency and effectiveness reviews;
- (d) EDP auditors (computer auditors).

8.9. In addition, it is necessary to consider career planning and counselling for staff to ensure their development is adequately monitored.

8.10. A further issue to be considered is the necessary training required to supplement the practical experience of internal auditors within the public sector. In this regard it would be necessary to consider the training requirements in the following areas:-

(a) formal core training;

(b) on the job training;

(c) external professional development.

8.11. The Committee believes that it is essential to improve the overall stature of internal audit and raise management's views and expectations of its capabilities in Order to obtain a commitment from management to provide the necessary skilled resources. There is a need for better planning and co-ordination of internal audit skills and resources.

8.12. The Committee does not consider it appropriate for it to stipulate minimum grades for internal audit nor that it prescribe minimum qualifications. Consistent with the role of advising senior management and reporting to the head of the authority, the heads of management audit units should themselves have equivalent status to senior management.

8.13. Further, if internal audit is to serve the broader role of reviewing efficiency and effectiveness, multidisciplinary skills will be necessary in the audit and a sound knowledge of management as a whole. A positive creative approach will also be necessary. Although accounting is essential for financial/compliance auditing it clearly is not mandatory in reviewing efficiency and effectiveness. The qualifications needed will obviously vary depending on the nature of activity audited. Skills in a range of disciplines may be needed such as industrial engineering, economics, computer sciences, operations research, business administration.

8.14. The Committee recommends:

That the proposed new Management Audit Advisory Unit provide guidelines on

(1) the appropriate grade and

(2) the appropriate qualifications for internal audit positions, based on the level and nature of the work they are performing.

That it be a prerequisite for unqualified staff to undertake an appropriate tertiary course of study and that they operate as assistants to a qualified person while they pursue their studies.

That all internal audit staff be required to receive not less professional development or training each year than required by professional accounting bodies to supplement their existing knowledge and to keep them abreast of new auditing development and skills.

That the training courses provided by professional or educational bodies are commended to departments/authorities for this purpose.

8.15. To attract and retain appropriately skilled employees in the internal audit role the Committee recommends that greater attention be given to career planning, It is necessary that auditors can either:-

(a) see opportunity for advancement within the internal audit function of their department or authority;

(b) see opportunity for advancement into a management position within their department or authority; or

(c) have an opportunity for transfer to a more senior position with another department or authority.

8.16. The Committee recommends that the Public Service Board should address the issue of career planning for internal auditors and act in a liaison capacity for the planning and counselling of internal audit staff within the public sector.

### Approach & Methodology

9.1. While this review did not address in detail the audit approach, methodology and reporting being adopted by current internal audit functions within the public sector, we have obtained information from the public hearings, submissions received from a number of interested parties and interviews with a number of selected departments.

9.2. The submission from The Institute of Internal Auditors -Australia indicates from their status review in November 1983 that approximately 30% of internal audits in N.S.W. government departments are transaction based as opposed to systems based audits. This was a significantly higher percentage than was found to exist for internal audits conducted by Commonwealth Departments in N.S.W.

9.3. Transaction based auditing was the generally accepted audit methodology adopted over a decade ago. At that time auditing was largely geared to the examination of a large sample of transactions with the object of assessing the extent of error and consequently deciding upon whether the accounting records as a whole could be relied upon.

9.4. With the general expansion in business and higher volumes of transactions, internal control and accounting systems have improved significantly, particularly with the expanded use of computers. As a consequence, the auditing profession has changed its approach to one which not only achieves a more effective result but one which also achieves a more scientific means of drawing a conclusion regarding the overall reliability of the accounting records. This has led to the development of the systems based audit approach whereby the auditor evaluates internal accounting controls and assesses compliance with those internal controls rather than scrutinising a large number of transactions.

9.5. In addition, the submission received from The Institute of Internal Auditors - Australia indicated that only 20% approximately of internal audit functions within the public sector catered for any form of EDP auditing. With the degree of computerisation within the N.S.W. public sector at the present time we believe that any internal audit methodology which does not consider or include a review of such computer systems and applications, could not be regarded as satisfactory.

9.6. Most authorities have some performance indicators which are reported regularly to management. Few, however, have a well developed system of performance measurement, integrated with their defined objectives. Even fewer have any form of comparison of their performance indicators with external standards, such as the performance of similar authorities in other states or other countries, or even performance over time. Consequently, internal audits currently conducted, do not generally review or report on the adequacy or accuracy of performance indicators.

#### Issues and recommendations

9.7. The overriding general issue coming out of this section is the need for internal audits, for both financial and compliance audits and efficiency and effectiveness reviews, to be conducted in accordance with an up to date approach and methodology which is appropriately constructed, well documented and effective in its application.

#### Financial and Compliance Audits

9.8. It is generally accepted that a comparison of the transaction based and systems based audit approaches reveals the latter to be more efficient and effective for the following reasons:-

- (a) the level of transactions tested is reduced significantly leading to a reduction in audit time;

- (b) the systems based audit recognises weaknesses in the accounting system which are the underlying cause of errors or irregularities which would be detected by a transaction audit. Thus it is oriented towards the future;

compliance testing of the recognised internal controls will then allow the auditor to assess whether the systems are operating as anticipated or if not, indicate the areas where they have broken down, so that appropriate remedial action can be taken.

9.9. The development of appropriate internal audit approaches and methodologies has been considered in many spheres in the past, by both the public and private sector in Australia and many overseas countries. However, research within Australia of the Commonwealth, Victoria and Queensland and overseas of the U.S., Canada and the U.K. indicates that a systems based audit approach is favoured.

9.10. In the Committee's opinion, an internal audit approach should be adopted which concentrates audit effort on control rather than solely the validity of historic transactions.

9.11. The Committee therefore recommends: the adoption throughout the N.S.W. public sector of a systems based audit approach whereby the internal auditor examines the total systems by:-

- (a) identifying and evaluating the controls on which management and ultimately the head of the department or authority relies to ensure the information produced is valid, complete and accurate;
- (b) identifying areas where efficiency and economy might be improved; and

- (c) ensuring the security of assets and the completeness of accounting for liabilities.

9.12. That the approach should be formalised, well documented and standard throughout all internal audit functions in the N.S.W. public sector. This approach should adopt a standard methodology which allows the internal auditor to:-

- {a) gain an understanding of the systems, through the use of flow charts or descriptions of the systems;
- (b) confirm, before each audit, that the systems continue to operate as documented;
- (c) evaluate the adequacy of controls and allow weaknesses to be reported to management;
- (d) prepare audit programs to test those controls which the audit has identified during the evaluation process;
- (e) test the department's or authority's system of internal control, using the programs developed, and report weaknesses to management;
- (f) react appropriately to any breakdowns or departures from the systems of internal control.

9.13. While recognising the right of departments/authorities to develop their internal audit function to suit the needs of the organisation's management, the Committee believes that a uniform or standardised approach to internal audit in the N.S.W. public sector would not only promote efficiency but would also assist in the overall areas of training and transfer of staff for internal auditors between departments and authorities. In addition, where systems are duplicated between departments or authorities, it would allow for the exchange of documentation, thus reducing the need to re-document the systems in



each user department. However, the Committee is aware of the need not to stifle initiative and the development of new approaches and the standards should be subject to regular review to take into account new approaches developed by organisations.

9.14. At present there are no formal government directives on the standards to be adopted by internal audit in the N.S.W. public sector. Although the Treasury has issued guidelines for internal auditors and a draft internal audit charter to be used by departments and authorities in establishing an internal audit function, these are not mandatory.

9.15. Under Section 9 (1) of the Public Finance & Audit Act, 1983, the Treasurer has the authority to issue directions which could enforce compliance with such standards on all departments and authorities. The text of Section 9 (1) is as follows:-

"The Treasurer may, from time to time, issue directions to accounting officers and officers of an authority with respect to the principles, practices and procedures to be observed in the administration of the financial affairs of the state and may, at any time, amend, vary or cancel a direction so issued."

9.16. The guidelines as presently issued therefore fall short of having legislative enforcement and are thus only a voluntary guide to department and authority heads and their respective internal audit functions.

9.17. The Institute of Internal Auditors - Australia in its submission to the Public Accounts Committee has stated that it is essential that standards which are relevant, properly supported and professionally competent be adopted by N.S.W. public sector internal auditors in a directed and co-ordinated manner. They see that formal standards are essential for the effectiveness of internal auditing and in this regard they believe the N.S.W. public sector should adopt the standards issued by their institute on an international basis.

9.18. The Treasury guidelines are headed "Treasury Guidelines for Internal Audit of Financial & Related Operations" and the introduction to those guidelines indicates that Treasury views an effective internal audit function as essential for the maintenance of efficiency and economy, as well as providing a basis for the review of internal financial and related operations and internal control systems of departments and/or authorities. However the standards do not address any aspects at all of efficiency or effectiveness auditing.

9.19. This was pointed out by The Institute of Internal Auditors -Australia in a letter to the Treasurer and in response the Treasurer recognised that the guidelines only dealt with one aspect of internal auditing, namely financial and compliance auditing. The Treasurer did, however, indicate that it was always the intention that the guidelines would be reviewed within twelve months after their inception. The guidelines were issued on the 1st May, 1984 and to date we are not aware of any intention to reissue, revise or replace these guidelines at the expiration of the year referred to by the Treasurer.

9.20. It is generally recognised that audit standards should at least comprise the following major elements:-

(a) General Standards

- the scope of the audit;

- the proficiency of audit staff; - independence of the auditor;

due professional care.

(b) Examination & Evaluation Standards

- planning and supervision of audit work;

- compliance with legal statutory regulations;

- evaluation of internal control;

- evidence of work performed.

(c) Reporting Standards

- distribution of audit reports;
- contents of audit reports.

9.21. Whilst the Treasury guidelines cover most of the above matters, their dealing with each matter is general and lacking in specific guidance to the auditor. In a letter from The Institute of Internal Auditors - Australia to the Treasurer, enclosing a detailed commentary on the guidelines, the Institute drew the following overall conclusion:-

"This commentary is severely critical of the document (the guidelines) which is regarded as limited in scope, incomplete, inconsistent and poorly expressed. The overwhelming feeling is that there is a substantial gap between the requirements of Section II of the Public Finance & Audit Act and the declared scope of the Treasury guidelines."

9.22. The Committee considers that the Treasury's initial guidelines are a useful first attempt at giving general direction to internal auditors within the N.S.W. public sector and has recommended that the proposed new Management Audit Advisory Unit prepare formal guidelines, extending to efficiency and effectiveness auditing.

9.23. In developing these guidelines the Management Audit Advisory Unit should have regard to the standards issued by the Institute of Internal Auditors, the Commonwealth Joint Implementation and Interdepartmental Advisory Committees on Internal Audit, and the Government Accounting Office (GAO) of the United States of America and the standards issued by other professional bodies. The Committee understands that the Auditing Standards Board of the Australian Accounting Research Foundation will in the future be putting forward new standards for both private and public sector audits.



## 10 IMPLEMENTATION

10.1. The responsibility for complying with the Public Finance and Audit Act and the Public Service Act and for implementing the recommendations of this Inquiry rests clearly with the Ministers and the heads of the relevant departments and authorities.

10.2. However, in the view of the Committee, a phased implementation is likely to prove the most successful. The Committee recommends therefore that each department/authority should be encouraged progressively and within two years to:-

(a) establish an internal audit unit, preferably styled: "Management Audit" unit, responsible to the head of authority, comprising the two functions of:-

(i) financial/compliance auditing

(ii) efficiency/effectiveness reviews;

(b) develop resources and skills, with the assistance of the central agencies as appropriate, to achieve fully effective systems based financial and compliance audit on a comprehensive planned cycle, within two years;

(c) over a similar time frame, develop specialised resources and skills in efficiency and effectiveness reviews, based on the specifications of objectives, performance measurement and management information systems, utilising as appropriate, the advice of the program evaluation unit, the Public Service Board's efficiency audit division, and/or contract consultants to develop methodology and

train staff. If the proposed Management Audit Advisory Unit is created, its service should also be used.

The head of the unit would co-ordinate and plan the activities of the two functions, which could be organised together or separately, as appropriate, in the Authority.

10.3. At the same time, and to support and co-ordinate the efforts of the departments/authorities, the Committee has recommended the establishment of a management audit advisory unit. The new unit would be responsible for developing audit and review standards, disseminating information on overseas and local experience to departments/authorities and co-ordinating the training and development of staff in respect of internal audit and performance review. This approach has proven successful at the Federal level, and the Committee should draw upon the experience and standards developed in the Commonwealth Public Service over the last eight years since the Joint Management Review on internal audit reported.

APPENDIX A

DEPARTMENTS AND ORGANISATIONS SURVEYED BY THE PUBLIC ACCOUNTS  
COMMITTEE

Premier's Department Auditor-General's Office Public Service Board Electoral Commissioner  
Ministry of Transport State Rail Authority Department of Health Treasury  
Department of Finance

State Lotteries Office

Department of Industrial Development

and Decentralisation

Government Supply Department Government Printer  
Department of the Attorney-General

and of Justice

Corporate Affairs Commission

Public Trust Office

Department of Consumer Affairs

Office of the Minister for Police and

Emergency Services

Police Department

State Emergency Service and Civil Defence  
Department of Lands  
Central Mapping Authority  
Valuer General's Department  
Public Works Department  
Land Coordination Unit  
Water Resources Commission  
Forestry Commission  
Office of the Minister for Education  
Department of Education  
Department of Technical and Further  
Education  
Department of Leisure, Sport and Tourism  
Department of Youth and Community Services  
Ministry of Aboriginal Affairs  
Department of Co-operative Societies  
Department of Mineral Resources  
Department of Industrial Relations  
N.S.W. Superannuation Office  
Department of Agriculture Soil Conservation Service  
Department of Environment and Planning  
State Pollution Control Commission  
Corrective Services Commission  
Department of Local Government  
Housing Commission



## APPENDIX B

### QUESTIONNAIRE RESULTS

#### Purpose and Scope

1. The inquiry is based on a questionnaire that was sent to all government departments and statutory authorities that receive funds from the Consolidated Fund. The initial questionnaire was distributed in early 1984 and a supplementary questionnaire was despatched in January, 1985 to the recipients of the original questionnaire to update the information collected.

2. The questionnaire was circulated to 44 government departments and statutory authorities. Of the organisations circulated, two departments were unable to respond in full to the questionnaire; the Department of Finance which was formed during 1982/83, was unable to provide information on all matters covered by the questionnaire, the Department of Local Government was an office of the Department of Local Government and Lands during 1982/83 and the information available separately on that Department was very limited. The follow up questionnaire was responded to by only 43 departments and authorities as the Central Mapping Authority became part of the Department of Lands in early 1985.

3. The responses to the questionnaire are briefly summarised below although certain specific findings have been referred to in various sections of this report.

#### Objectives and Performance Measurement

4. Very few authorities had clearly enunciated organisation wide objectives. In many cases, there was no statement of objectives, other than the program objectives developed for program budgeting in consultation with Treasury. In only 5 cases was the organisation able to identify overall organisation objectives other than those established for the programs. Most program objectives cited were not true objectives setting out the results or outputs to be achieved, but rather, statements or functions, describing what the organisation does.

5. The responses to the questionnaire indicate that the monitoring of objectives relies heavily on subjective judgement supported by a comparison with budgets and a review of trends. No organisation identified that it monitored its performance by reference to the performance of similar organisations in other states or overseas, although the Department of Education provided, subsequent to the questionnaire and public hearing, a paper on performance indicators in education, which referred to a comparative study of H.S.Co Language Syllabuses and Examinations (1980) with London Advanced Level G.C.E. courses, which in the opinion of the Department, provided a valuable external opinion on the standards of N.S.W. courses.

### Performance Improvement Mechanisms

6. 38 organisations indicated that they were subject to some sort of external review since January 11, 1980. 14 of such reviews were carried out by the Auditor-General in his annual review.

### Internal Audit

7. Although 34 (79%) of the organisations covered by the questionnaire reported the existence of an Internal Audit section, of a total of 233 Internal Audit staff employed in 1984 by the organisations covered, only 43 employees were members of either the Institute of Chartered Accountants or Australian Society of Accountants, and a further 70 were reported as having tertiary degrees.

8. On average, only 22% of Internal Audit time is spent on the assessment of efficiency and effectiveness. Only 8 departments spent 30% or more of their time in these areas. The greatest effort is spent on the evaluation of internal control and the assessment of compliance with statutes or regulations.

### Efficiency and Effectiveness Reviews

9. The majority of organisations with an Internal Audit function which conducted efficiency and effectiveness reviews also commissioned outside units to conduct such reviews.

	Efficiency	Effectiveness
Internal review only	3	3
Also commissioned outside body to review	14	8
Total Internal Audit Units looking at Efficiency and Effectiveness	--	--
	17	11
No such review	17	23
No Internal Audit Unit	9	9
	43	43

10. Authorities identified a range of means by which efficiency and effectiveness had been improved. Those most commonly identified were:-

- (a) computerisation
- (b) restructuring

### Cost Information

11. 33% of organisations identified that cost savings were made, at least in part, by the curtailment of services. However, only 20% had set targets for cost savings. One organisation, The Forestry Commission of N.S.W. indicated that major cost savings had been made but could not isolate the exact reason for the savings.

## Detailed Questionnaire Results

12. The detailed findings are set out in the following attachment to this appendix.

## DETAILED QUESTIONNAIRE RESULTS

This attachment summarises the results of a comprehensive questionnaire issued to government departments and statutory authorities in July 1984, relating to the 1982/83 year, and a second smaller update questionnaire issued in January 1985 relating to the 1983/84 year.

44 organisations responded to the first questionnaire, and 43 to the second, as the Central Mapping Authority became part of the Department of Lands in early 1985 and did not respond to the second survey.

% specified	Efficiency	Effectiveness
	No. of organisations specifying	No. of organisations specifying
1 - 10%	5	4
11 - 20%	5	4
21 - 30%	5	-
31 - 40%	1	1
41 - 50%	1	1
71 - 80%	-	1
	17	11
Did not carry out effectiveness reviews		5
No details	2	3
	19	19
Average of those specifying	19 %	23 %

2.6. Did any unit other than internal audit conduct efficiency and effectiveness reviews during 1984

efficiency reviews

effectiveness reviews

	No of Organisations Specifying	Efficiency	Effectiveness
Yes	28	22	
No	15	21	
	43	43	

2.7. Please list all recommendations made in 1982-83 for improvements in efficiency and effectiveness made as the result of external reviews (refer question 2.1), internal audits and special internal management reviews and whether or not each recommendation had been carried out. (Please indicate whether any of these recommendations are considered confidential.)

The reviews carried out are analysed as follows:

	Reasonable or very detailed review	Minor review	Implementation of recommendations %
External Consultants	8	0	75
Public Service Board	14	3	89
Premier's Department	1	0	75
Internal Audit	6	2	75
Other Internal Review	10	4	84
	39	9	80

Note: In 14 cases insufficient information was supplied to complete the above table. In several of these instances confidentiality was quoted as the reason for non-disclosure.

#### 2.8. How did you evaluate the benefits of efficiency and effectiveness reviews in 1982-837

	Evaluated by the stated method only	Evaluated by the stated and other methods
Subjective judgement	10	17
Counting recommendations implemented	4	11
Benefit cost analysis	5	16
Other 0	0	
Not applicable	6	0

#### 2.9. What other general management initiatives were taken during 1982-83 other than those referred to above, to improve the efficiency and effectiveness of your organisation?

36 of the 44 organisations questioned identified the following management initiatives:

	Number
Computerisation	14
Restructuring of part of the organisation	16
Restructuring of the staff	11
Management information systems	13
Training	5
New services	4
Marketing and advertising	3
Energy saving schemes	2
Initiatives specific to the organisation	14

#### 2.10. Were there any major obstacles or constraints (other than budgetary constraints) to improved efficiency and effectiveness in your organisation in 1982-837 If so, please explain the nature and effect of these obstacles and constraints.

Restrictions to efficiency and effectiveness were reported with the following frequency:

- B12 -

	Number	%
Number of staff	22	51
Experience/level of staff	9	21
Other restrictions	9	21
Staff structure	4	9
No restrictions	7	16
Union involvement	5	12

Note: One organisation did not supply the necessary information to answer this question.

Most organisations experienced more than one restriction.

2.11. What measures were taken to involve employees in the process of improving efficiency and effectiveness in 1982-83?

The following measures were reported as having been adopted:

	Organisations adopting the measure	
	Number	%
Management/Supervisor meetings	14	32
Staff meetings	17	39
Committee	13	30
Training	11	25
Suggestion Scheme Award	14	32
Union Meetings	4	9
Other involvement	4	9
No involvement	1	2

Note: One organisation did not supply the necessary information to answer this question. Most organisations involved staff in more than one way.

2.12. In your opinion what was the most significant area of improvement in the performance of your organisation in 1982-83?

36 of the 44 organisations questioned specified the following significant areas of improvement:

	Number	%
Computerisation	6	14
Restructuring of part of the organisation	6	14
Restructuring of the staff	5	11
Management information systems	9	20
Training	3	7
New services introduced	6	14
Planning improvements	2	5
Improvements specific to the organisation	11	25

2.13. Did your organisation monitor the handling of complaints from the public about the efficiency and effectiveness of your organisation in 1982-83?

64% of organisations indicated that they monitored the handling of complaints.

Note: Two organisations were unable to provide information of any relevance as they were either formed or reorganised during 1982-83.

2.14. Were impressions and comments elicited from the organisation's customers and the general public about its efficiency and effectiveness in 1982-83? 59% of organisations indicated that they elicited impressions and comments from the general public.

Note: Two organisations were unable to provide information of any relevance as they were either formed or reorganised, during 1982-83.

One other organisation did not supply the necessary information to answer this question.

### 3. COST INFORMATION

3.1. What major cost savings have resulted from any of the above reviews or from management initiatives during 1984? If savings were achieved, were they the result of the curtailment or elimination of services or of improved efficiency?

	Number	%
Cost savings exclusively by curtailment of services	1	2
Cost savings exclusively by improvements in efficiency	3	30
Cost savings by a combination of the two	14	33
No cost savings identified	10	24
Not applicable/No review	5	11
	43	100%

3.2. How are costs monitored by senior management on a regular basis? What are the form and timing of cost reports and what is the position of the officer receiving such reports?



	<u>Number of Staff</u>	<u>(a) Number of Internal Audit Graded Staff</u>		<u>Internal Audit Staff</u>	<u>Existence of Efficiency Review</u>	<u>Average Sick Days per Employee</u>	<u>Average Hours Overtime paid per Employee</u>	<u>Workers Comp. Claims</u>	
	<u>31.12.83</u>	<u>31.12.84</u>	<u>31.12.83</u>	<u>Full time F Part time P</u>	<u>Unit Y/N</u>	<u>1983</u>	<u>1983</u>	<u>Number per 100 Employees</u>	<u>1983</u>
Department of Finance	625	6	6	F	N	9.9	24.0	41	6.6
Auditor General's Office	183	(g)	(g)	(g)	Y	6.7	4.4	12	6.6
Public Service Board	366	[	1	F	N	7.5	11.7	19	5.2
State Electoral Office	26			-	N	8.0	3.0	1	3.8
Ministry of Transport	79			-	N	7.0	8.0	2	2.5
State Rail Authority	40,367	26	14	F	Y	10.5	82.9	11,631	28.8
Department of Health	12,901	31 (h)	31 (h)	F,P	N	11.8	45.2	2,521	19.5
Government Supply Dept.	12,389	5	5	F	Y	8.1	t.1	1,479	11.9
Dept. of Technical and Further Education	8,309	12	12	F	N	5.6	106. O (i)	438	5.3
Dept. of Youth & Community Services	(e)	8	5	F	Y	(e)	(e)	(e)	(e)
Ministry of Aboriginal Affairs	15	-	-	-	N	5.0	9.3	-	-
Department of Co-operative Societies	62			-	N	7.0	5.1	&	6.5
{ Dept. of Mineral Resources	438	1	2	F	Y	(e)	8.3	39	8.9
Dept. of Industrial Relations	1,089	3	1	F	Y	7.8	3.9	57	5.2
"] NSW Superannuation Office	55		1	P	Y	7.7	91.7	-	-
I Dept. of Agriculture	3,512	8	7	F	N	6.1	17.4	373	10.6
Soil Conservation Service	721	3	3	F	Y	(e)	16.1	74	10.3
Dept. of Environment and Planning	495	2	2	F	N	6.4	2.9	18	3.6
Dept. of Corrective Services	2,560	6	6	F	Y	12.9	243.9	438	17.1
Dept. of Local Government	(J)		(j)	F	N	(J)	(J)	(J)	(J)
Housing Commission of NSW	1,425	4	3	F	Y	6.6	14.8	101	7.1
Department of Leisure, Sport and Tourism	410	2	2	F	N	5.4	12.5	90	22.0
State Pollution Control Commission	251	-	-	-	N	6.3	3.6	12	4.8
Total	172,165	233	199					22,069	
Average	4,099	6.9	6.2			8.3	38.&		12.8

(g) Auditor General's Office - internal audit function is undertaken on a rotational basis by professionally qualified accountants freinternal resources.

(h) The Department of Health figures include those who spend more than 20% of their time on the Internal Audit function. The above Internal Audit Staff numbers include a number of positions that were vacant at 31.12.84.

Refers to teaching staff only.

(J) In 1982/83 the Dept. of Local Government existed as an office of the Dept. of Local Government and Lands. See the Department of Lands for a combined reply for both departments for the questions indicated by (I).

## APPENDIX C

### EXPERIENCE IN OTHER GOVERNMENTS

1. Experience in the conduct of the internal audit function within other governments in Australia and overseas is indicated in the following brief review.

#### The Australian Experience

##### Commonwealth of Australia

2. The Public Service Act 1922 - 81 section 25 (2) specifies that the Permanent Head of a Department shall be responsible for its general working and for all the business thereof, and shall advise the Minister in all matters relating to the Department.

3. Section 48C (1) of the Audit Act 1901-1980 authorises the Auditor-General to carry out efficiency audits of departments, and public authorities of the Commonwealth and Commonwealth organisations. An efficiency audit unit was established in the Auditor-General's office and has carried out a number of efficiency audits. Recently, however, the Auditor-General has decided to disperse his specialist efficiency auditing staff throughout the office's ordinary auditing divisions.

4. With respect to internal audit, the Public Service Board conducted a Joint Management Review of this function in 1977 within the Commonwealth Public Service. Following the review it was recommended that the Commonwealth Government's internal audit function should encompass the following scope:-

- (a) compliance and efficiency of financial systems;

- (b) compliance and efficiency of all departmental operations;
- (c) effectiveness of results achieved by departments against objectives, where these have been defined by management and are measurable.

5. The Commonwealth established an Interdepartmental Advisory Committee on Internal Audit and a Joint Implementation Committee on Internal Audit to assist the Public Service and departments in implementing follow up action arising from the Joint Management Review. These Committees play a role in advising and training in internal auditing matters and in monitoring the effectiveness of internal auditing across the Public Service.

6. In August, 1984, the Departmental Advisory Committee on Internal Audit issued the booklet "Guidelines for Internal Audit in the Australian Public Service".

7. These guidelines are in accordance with the recommendations indicated above. In summary the Guidelines define the role and scope of internal audit as follows:-

#### Role

"Internal audit is an independent function which carries out a systematic review and appraisal of all departmental operations for the purpose of advising management as to the efficiency, economy and effectiveness of the organisation's policies. It is a recommended means of assisting senior management to fulfil their responsibility for the administration of an organisation.

#### Scope

"Internal audit activity may cover all aspects of a department's operations. A competent internal audit group can assess and express opinions in such aspects as:-

- (a) the design, development, implementation and operation of systems, procedures, processes and controls, whether manual or computer-based;

- (b) the reliability and adequacy of information available for decision-making and for accountability purposes;
- (c) the economy, efficiency and effectiveness with which resources are being used;
- (d) the adequacy of protection afforded public funds and assets;
- (e) the extent of compliance with legislative and departmental operations."

8. The Public Service Board's report for 1983 indicates that in respect of internal auditing, 62 in-service training courses and seminars, together with presentations by Australian and overseas experts, were sponsored or conducted for a total of 900 participants, or 30% increase in 1982-83. Emphasis, it was reported, was placed on developing and conducting courses to provide internal and A.D.P. staff with A.D.P. audit skills. Over 400 participants attended 25 courses and seminars in advanced A.D.P. audit topics during the year. Thirty courses on basic systems, based audit and A.D.P. audit were attended by some 400 staff. Other specialist seminars and workshops also were conducted.

9. It was also reported that departments and local internal audit groups conducted their own courses in several states and on several occasions included state public servants.

10. Recent developments at the federal level include that:-

- (a) the Auditor-General has indicated his intention to disperse his specialist efficiency auditing staff throughout the office's ordinary auditing divisions as part of the move towards comprehensive auditing which will include both efficiency and financial compliance considerations;

- (b) the Federal Department of Finance is undertaking a management improvement programme based upon identifying indicators of expenditure program outputs;
- (c) prior to the recent federal election, the House of Representatives Expenditure Review Committee had expressed concern regarding possible lack of co-ordinated mechanisms to review efficiency, particularly having regard to the re-organisation referred to above in the Auditor-General's Department, and consequently they had initiated a review into efficiency assessment mechanisms in the Public Service;
- (d) the Joint Committee of Public Accounts, in its 211th report, 1983, published a Finance Minute in Report 184 - Internal Audit in the Australian Public Service. It concluded, inter alia, that:-

"the Committee regards internal audit as an essential means by which management may monitor the effectiveness of management controls and keep informed of the reliability and appropriateness of 'the systems and procedures it employs. This report did not result from a specific reference or inquiry. Instead, it is a discussion paper arising from the Committee's long standing interest in the quality of administration within the Public Service, and a desire to support the Public Service Board's initiatives in this area .....

". ..... previous attempts to improve internal audit in the Australian Public Service have been generally unsuccessful. It is clear that those failures resulted from insufficient interest on the part of permanent and statutory heads and a lack of support for internal audit by senior management - a

situation exacerbated by the low standard of internal audit itself. The findings of the 1977 Public Service Board review of Internal Audit focused attention on the dismal state of internal audit in the Public Service and stimulated renewed efforts to bring about improvements. The Public Service Board has initiated action designed to upgrade internal audit. Its success will depend entirely on the support given by individual departments and authorities.

"The 184th report stresses that it is essential that the heads of departments and authorities cultivate a genuine interest in internal audit and learn to use it effectively. The tendency for many Permanent Heads to concentrate on policy matters and ignore administrative and financial affairs cannot be condoned, particularly in the light of section 2AB of the Audit Act, 1901.

"In addition, officers who are motivated, qualified, experienced and capable must be encouraged to enter internal audit so that it can attain its full potential."

Victoria

11. The Victorian Public Service Act 1958 charges the Public Service Board (section 5[2] with the function of devising means for promoting efficiency in the workings of departments. Section 2(2) of the same Act directs that the permanent head of a department shall be responsible for its general working and for the transactions of business thereof.

12. In March 1981, the Public Bodies Review Committee published a report on a study of the Audit and Reporting responsibilities of public bodies in Victoria. In that report, internal audit was reviewed in some depth, based on detailed examination of a number of public bodies. Some of the conclusions were:-

## "Internal Audit Role

"The internal auditors should, in our view, be responsible for satisfying themselves that:-

the internal financial control procedures are appropriate and adequate and that no weaknesses are present which involve financial risk;

the management control procedures are appropriate and adequate and that no weaknesses are present which reduce the effectiveness of management because of inadequate, insufficient or untimely information;

- the financial and management control procedures are adequately documented and that relevant staff are familiar with, understand and operate the procedures;
- the information presented in management reports is accurate, timely and relevant;

and that, further, the internal auditors should be responsible for:-

- taking appropriate action in respect of recommendations made in external auditors' reports;
- conducting internal systems reviews at the request of management;
- examining the proposed control procedures in respect of new activities, systems and methods and reporting on their adequacy;

- recommending changes to control procedures where weaknesses have been detected;

and for:-

- presenting written reports on the audit to the management of the body subject to audit and to the relevant minister.

#### "Efficiency Audits

"The responsibility for particular aspects of administrative efficiency in Government has been vested in various controlling bodies. These typically include the equivalent of a Public Service Board, a Treasury or Department of Finance and the Auditor-General's Department. In Australia, Public Service Boards have undertaken efficiency audits of government operations for a number of years, particularly in New South Wales. However, with the exception of the New South Wales Public Service Board, the Boards appear to have generally taken a passive role, acting only on specific requests or instructions in undertaking efficiency audits.

#### "Effectiveness Audits

"There appears to be little evidence in Australia at present, at the Commonwealth level or in any State, of a serious attempt at measuring the effectiveness of government programs. The most constructive and beneficial work in this area has been undertaken by the Parliamentary Standing Committees such as the Committee on Government and Finance Operations in Canberra and the Public Bodies Review Committee in Victoria.

"The Coombs Report concluded that at the Commonwealth level the task of reviewing the effectiveness of government programs could best be done from within the Department of the Prime



Minister and Cabinet. In the Prime Minister's announcement in respect of the splitting of the Treasury in 1976 the functions of the new Department of Finance were to include:-

"participation in evaluation of the effectiveness of expenditure programs in meeting Government determined objectives."

"Little evidence of the implementation of these initiatives has been seen to date.

"It might be too ambitious in the short term to follow the United States and West German approach and to expect the Victorian Public Body auditors to embrace the responsibility for measuring effectiveness as well as efficiency. However, it would appear reasonable to consider the Canadian example at an early stage and therefore place responsibility on an auditor to ensure that satisfactory procedures have been established to measure and report on the effectiveness of programs.

"Management and administration of Public Bodies

"The performance of efficiency and effectiveness audits will not, in themselves, improve the performance of public bodies. This will require those responsible for the management of the bodies to set standards for efficiency and to decide the manner in which performance against objectives will be monitored. Unless public bodies have adequate management and personnel skills to develop and operate appropriate information systems, and the necessary management infrastructure to act upon that information, the question of achieving efficient and effective operation remains academic.

## "Management Information Systems

"Timely, accurate and comprehensible information needs to be available to public body management to provide a basis for meaningful decision making in respect of efficiency and effectiveness within public bodies. In order to achieve the desired results, two approaches that might be examined with advantage are:-

corporate planning, and  
management by objectives.

"The Management Board of Cabinet of Ontario, Canada, as part of its central management responsibilities, establishes and supervises administrative policies, procedures, management functions and systems for the operation of the Ontario Public Service. In this respect, one of the initiatives of the Management Board of Cabinet was the introduction in 1973 of Managing By Results (MBR).

## "AUDITSKILL REQUIREMENTS

"In this section of the report, we consider the audit skill requirements associated with the need for adequate levels of audit for all Victorian public bodies. The scope of audit proposed in this report envisages the need for audit teams who collectively possess a range of skills. The range of investigation and analysis necessary to conduct audits in the effectiveness, efficiency, finance and compliance fields will require high levels of skill and experience supplemented by continuing training and upgrading.

"If the audit process is to make a positive and effective contribution to the accountability of public bodies to Government, Parliament and the electorate then it is essential that manpower with the requisite levels of skill and experience is made available.

## "Financial and Compliance

"In this area, the audit skills required will continue to be those of professional auditors and accountants. We believe that it will be necessary to ensure that the financial and compliance audit teams include auditors with system-based auditing and computer auditing skills together with experience in the appraisal of legal compliance as well as financial control mechanisms.

"Internal auditors in this field of audit should also possess experience in the area of control and particular reference to the appraisal and development of administrative, management and financial control procedures.

## "Efficiency

"In section 10.4.2 of this report, we outlined the proposed approach to Efficiency Auditing and identified skill requirements in:-

financial and compliance audit; business common-sense; activity sampling; work measurement; business statistics; method study; procedural analysis; engineering; computer skills; communications; equipment; and records management.

"These skills should not be expected in any single individual but should be available to the audit team as a whole either from within the total audit resource or by the co-option of individuals on a temporary basis.

"We see little difference in skill requirements between internal and external efficiency auditors except for the fact that internal efficiency auditors should have greater experience in the development and installation of management controls.

"Effectiveness

"The outline steps of effectiveness auditing were considered in section 10.4.3 of this report in which it was suggested that effectiveness audits would normally be carried out by a team of auditors who collectively possess skills in:-

- management organisation
- business statistics
- project planning and control techniques
- human resource management
- office procedures
- capital project appraisal
- appropriate current technical skills."

13. Recently, in conjunction with the recommendations of the Economic and Budget Review Committee, an Internal Audit Division was established within the Department of Management and Budget.

14. The Division has initiated an internal audit program with the objective of upgrading the internal audit function within government organisations.

15. It is understood that the anticipated scope to be ascribed to internal audit encompasses -

- (a) compliance reviews;
- (b) efficiency reviews;
- (c) effectiveness reviews, to the extent that resources are effectively deployed in delivery of designated programs.

16. It is also understood that a central "internal audit" servicing organisation is being established to provide this type of audit to governmental organisations which are too small to provide the service themselves, and to co-ordinate the training and development of internal auditors.

#### Queensland

17. Having regard to sections 35 and 36 of the Financial Administration and Audit Act 1977, the permanent head of each department is the designated accountable officer who shall ensure among other things, as far as practicable, that value for money is obtained for expenditure incurred and that there are procedures within departments and internal checks to ensure that there are adequate safeguards with respect to departmental financial administration and its effectiveness. This Act also imposes an obligation upon the permanent head, as the accountable officer, to examine the need to establish an internal audit organisation.

18. It is understood that only a limited number of internal audit organisations were established within departments under this arrangement and that the present trend is to refer financial compliance responsibilities to line managers and instead create internal operational audit sections. Recently the Government established an "internal" operational audit service to assist departments which are too small to provide their own service.

## South Australia

19. In terms of the Public Service Act 1967~75, section 19, the Public Service Board has the powers and functions, among others, of devising means for effecting economies and promoting efficiency in the management and workings of departments and of maintaining a continuous system of checking to ensure the economical and efficient working of departments.

20. In terms of section 27 of that Act and subject to section 19 of the Act, the permanent head is responsible for the general working of the department and for all the business thereof.

21. Arising from reported comments by the Auditor-General, the Auditor--General's Department and the Public Service Board encouraged, within the past few years, the establishment as a pilot exercise of internal-audit functions within three departments.

22. Generally, except for some trading authorities, the internal audit function has not expanded in South Australia to the extent desired.

## Overseas Experience

### Canada

23. Internal audit was first recognised in Canada as an important element in government organisation by the Glassco Royal Commission of 1962, although not until the 1970's was the issue taken seriously.

24. The Treasury Board in 1977 required all departments and agencies to establish an on-going program evaluation function. In 1978 the office of the Comptroller General was constituted to ensure the development and on-going operation of program evaluation in departments and agencies.

25. Each government organisation is expected to have appropriate policies, practices, organisation and funding for program evaluation.

26. Program evaluation requires answers to four basic questions -

(1) Does the program make sense?

i.e. to what extent are the objectives and mandate of the program still relevant?  
- are the activities and outputs of the program consistent with its mandate and plausibly linked to the attainment of the objectives and the intended impacts and effects?

(2) What has happened as a result of the program?

i.e. - what impacts and effects, both internal and external, resulted from carrying out the program?  
- in what manner and to what extent does the program complement, duplicate, develop or work at cross-purposes with other programs?

(3) Has the program achieved what was expected?

i.e. - in what manner and to what extent were appropriate program objectives achieved as a result of the program?

(4) Are there better ways of achieving the results?

i.e. - are there more cost-effective alternative programs which might achieve the objectives and intended impacts and effects?  
- are there more cost-effective ways of delivering the existing program?

27. This system of evaluation is regarded as an integral part of the Government's Expenditure Management System based upon programs.

28. Internal audit is distinguished from program evaluation on the basis that:

- (1) internal audit assesses the internal effectiveness of management practices, whereas
- (2) program evaluation, on the other hand, extends beyond this to evaluate the results of programs in the external environment and the basic rationale of such programs.

29. Also in 1978, the Comptroller General's Office (CGO) first developed and issued "Standards for Internal Financial Audit in the Government of Canada". In addition the CGO established an Internal Audit and Special Studies Division to assist and guide departments in establishing internal audit units.

30. The division helped and advised departments in preparing policies and plans, staffing senior positions, developing audit methodology and designing and delivering audit training. The division also conducted regular, formal quality assurance reviews of internal audit units, and recommended improvements to Deputy Ministers.

31. Generally, the CGO established three priorities in its quest for more effective internal audit. These were:-

- (a) Firstly, the CGO assisted departments establish an appropriate audit structure. This structure would include departmental policy, organisation, reporting relationship, audit committees, long term and annual plans and annual reports to deputy heads;
- (b) Secondly, the CGO would develop appropriate audit methodology for conducting non-financial audits. Appropriate training for audit staff with emphasis on the conduct and reporting of individual units was also established.



Thirdly, the CGO encouraged better quality audits and audit reports in all departments. This would lead to increased and more formal reliance by Central Agencies on internal audit in assessing legislative compliance.

32. Subsequently, internal audit functions were given more resources and increased visibility through higher reporting levels. The classification of the heads of audit were upgraded and staff reporting levels improved.

33. The next milestone in the development of internal auditing in Canada came in 1984 with the introduction of Bill C-24 which created a new internal audit mandate for Crown Corporations. Up until this time the role of internal audit was not statutorily regulated and thus the extent of internal audit, particularly as it related to "comprehensive" auditing, was so varied in practice, that positive assurance could not be guaranteed.

34. However, for the first time with the passage of Bill C-24, the auditor has a legal statutory obligation to give positive assurance about value for money matters.

35. Bill C-24 requires each Crown Corporation to maintain, in addition to books of account and records, "financial and management control and information systems and management practices" that will provide, among other things, "reasonable assurance that the financial, human and physical resources of the corporation are managed economically and efficiently and the operations of the corporation are carried out effectively". It also explicitly requires internal auditors to assess compliance with this mandate and calls for special examiners to independently determine every five years, whether the systems and practices do provide the necessary reasonable assurances.

36. At this point in time there is some debate as to who will conduct the ongoing internal audit function and the five yearly special examinations. It is generally thought that the ongoing internal audit function will be handled by either in-house internal audit units, consultant internal auditors or a combination of the two where the

in-house unit may not have the necessary skills to competently undertake aspects of the value for money auditing. However, the overwhelming feeling at the recent annual Canadian Comprehensive Auditing Foundation Conference was that the five yearly special examinations would almost certainly be conducted by consultant auditors.

#### United Kingdom

37. In May 1982 the Government introduced a financial management initiative to improve the allocation, management and control of resources throughout central government.

38. The objectives of this programme are to promote in each department an organisation and a system in which managers have -

- (1) objectives and measures of performance against objectives;
- (2) responsibility for making best use of resources at their disposal;
- (3) information, particularly about costs, and the training and access to expert advice they may need in respect to the above.

39. With respect to resources the Government consumes itself, implementation has been directed towards dividing departments' work into cost centres, making managers accountable for the management of the costs within their control and for the results they achieve; and establishing procedures, information systems and measures for setting targets and budgets against which performance may be judged.

40. Regarding expenditure largely external to government departments, e.g. road construction, implementation has been directed towards determining controllability of expenditures in respect of each manager and then accountability of the Manager and analysis of cost-effectiveness of programs.

41. One theme of this program is to achieve close co-ordination of staff inspection, internal audit and management services/functions.

42. Internal audit has been defined as being concerned with the effectiveness of a department's internal controls, financial and otherwise, supplementing the primary responsibility of the managers in each line of command.

43. In this regard many departmental internal audits have been restructured and the professionalism of the staff is being improved.

U.S.A.

44. The General Accounting Office (GAO) headed by the Comptroller-General of the United States has been conducting 'expanded' audits, covering financial/compliance, efficiency/economy and program results, for many years. Practices for internal auditing in the individual States and at local government levels vary widely. To assist small agencies with their internal auditing, three different approaches have been used:-

- (a) General Services Administration provides internal audit services to a number of small agencies and commissions;
- (b) cross-servicing arrangements between agencies are encouraged;
- (c) use of state and local government auditors and public accountants, particularly for the auditing of grants and federally funded programs.

## APPENDIX D

### GLOSSARY OF TERMS

#### Accountability

"...the obligation to answer for a responsibility that has been conferred. It presumes the existence of at least two parties: one who allocates responsibility and one who accepts it with the undertaking to report upon the manner in which it has been discharged."

(Report of the Independent Committee for the Review of the Office of the Auditor-General of Canada, [page 9 Ottawa: Information Canada, 1975])

#### Performance Measurement

The measurement of performance in N.S.W. public sector authorities is concerned with their :-

- (a) effectiveness in achieving objectives
- (b) efficiency and economy with which objectives are achieved.

#### Effectiveness

Effectiveness is an absolute term. An activity is fully effective if it achieves all its objectives,

#### Efficiency

Efficiency relates to the conversion of inputs to outputs. A unit or program is more efficient than the standard if it achieves its actual outputs using less inputs (or, in money terms, lower cost) than the standard for that output.

## Economy

Economy is really a subset of efficiency. It is popularly used to describe the objective of acquiring resources (or inputs) at least cost, measured by the relative unit cost of purchases, wages, finance etc.

## Internal Control

Internal control comprises the plan of organisation and all of the co-ordinate methods and measures adopted within an organisation to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognises that a "system" of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments (AICPA Auditing Standards).

## Internal Audit

The Committee accepts the definition of internal audit as defined by the Comptroller-General of Canada as:-

"... the systematic, independent review and appraisal of all departmental operations, including administrative activities, for purposes of advising management as to the efficiency, economy and effectiveness of the internal management practices and controls."

Traditionally, internal auditing in the public sector was confined mainly to an examination of the propriety and compliance with regulations of financial transactions and the security of public monies and other assets. In recent years, the role of internal audit has expanded with more emphasis being placed on the economy, efficiency and effectiveness with which public resources are being used.

Financial and Compliance Audit This determines :-

- (a) whether financial operations are properly conducted;
- (b) whether the financial reports of an audited entity are presented fairly;
- (c) whether the entity has complied with applicable laws and regulations;
- (d) whether assets are safeguarded and liabilities recognised.

Synonyms

Within broad limits the following are considered to equate with "financial and compliance audit":-

- attest audit;
- regularity audit;
- procedural audit;
- security audit.

Efficiency and Economy Audit and Review

Efficiency refers to the relationship between goods or services produced {outputs} and the resources used to produce them {inputs}. Economy refers to the terms and conditions under which the government acquires financial, human and physical resources (inputs).

An efficiency audit or review determines whether the organisation is managing or utilising its resources (personnel, property, space, and so forth) in a relatively efficient and economical

manner and the causes of any inefficiencies or uneconomical practices, including inadequacies in management information systems, administrative procedures, or organisational structure.

#### Synonyms

Within broad limits the following are considered to equate with "efficiency audit" or "efficiency review":-

management audit;  
operational audit.

#### Effectiveness Audit or Review

An effectiveness audit or review determines whether the intended goals or results (outputs) of programs are achieved, whether the objectives established by the legislature or other authorising body are being met.

#### Synonyms

Within broad limits the following are considered to equate with "effectiveness audit" or "effectiveness review":-

results audit;  
program audit.

#### Program Evaluation

There is no agreement in the literature of what program evaluation should entail. The terminology used varies widely and is itself the cause of much confusion. Simply stated, program evaluation is the formal assessment of the continued relevance and of the effectiveness of existing programs. That is, it involves the systematic gathering of verifiable information on a program and demonstrable evidence of its results. The Office of the Comptroller General of Canada, in discussing program evaluation, has expanded on this:-

"Program evaluation is the periodic, independent and objective review and assessment of a program to determine in light of present circumstances, the adequacy of its objectives, its design and its results, both intended and unintended. Evaluations will call into question the very existence of the program. Matters such as the rationale for the program, its impact on the public, and its cost effectiveness as compared with alternative means of program delivery, are reviewed."

In this context a program is a group of government activities, powers or functions that can be related in a logical fashion to a given objective or set of objectives. A program evaluation goes beyond reviewing the effectiveness or performance against stated objectives, and questions the very existence and need for the program. It is concerned with evaluating government policy and assessing its relevance to public needs.



Date of Meeting	Organisations Represented and Witnesses
11 December, 1984	Premier's Department * Mr. Gerald Gleeson Secretary
11 December, 1984	Department of Youth and Community Services * Mr. Heinz Heilpern Director-General * Mr. Peter Dale Darren Deputy Director-General * Ms. Beth McIntyre Director, Administration
12 December, 1984	New South Wales Treasury * Mr. Norman Oakes Secretary & Comptroller of Accounts * Mr. Kenneth John Gibson Deputy Secretary * Mr. Robert Scullion Chief Accountant
12 December, 1984	Institute of Internal Auditors * Mr. Barry Stanfield Leithhead Senior Vice President * Ms. Margaret Leslie Campbell Chairperson, Government Liaison Committee

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