



# Auditing

*in the Public Interest*

AUTUMN 2003

## A FLURRY of activity

The latter end of Autumn and Spring each year usually sees a flurry of activity in my Office finalising the completion and subsequent arranging for the tabling of a variety of reports on the results of audits to Parliament. This year has been no exception, as indicated elsewhere in this newsletter.

The range of topics covered by the studies conducted over the past months has been broad indeed, reflecting the wide range of services performed and activities undertaken in the Victorian public sector. While some of the topics will be familiar to regular observers of the Office's reports, some are new and I would draw readers' attention to them.

Last year, we commenced a range of studies which we will continue focusing on the quality of operation of core administrative systems of public bodies. This year, that focus was on payroll processing and management of the GST. These studies were undertaken primarily because the Annual Financial Statement audit doesn't in itself, provide the necessary depth of assurance that public sector managers, parliamentarians and the community require about core business operations.

Of particular note is our report on *Parliamentary control and management of appropriations* which examined the impact of some of the financial reforms over recent years on Parliament's ability to effectively hold Executive Government to account.

I would commend that particular report to those who have an interest in parliamentary affairs.

Notwithstanding the reporting season, much has been happening with accounting standards in recent times, and the public sector is not immune from those changes. Three specific standards for the public sector, i.e. AAS 27: *Accounting in Local Government*, AAS 29: *Accounting in Government Departments* and AAS 31: *Accounting for Whole of Government*, have been the subject of review by the Australian Accounting Standards Board.

At the same time, the pace of the international accounting standard harmonisation process has picked up considerably following the announcement that Australia will seek to harmonise its accounting standards with the international standards by 1 January 2005. These initiatives do affect the public sector because accounting standards will change in Australia. The accounting standards that are issued here in Australia will reflect the IFAC Public Sector Committee's standards as well. To assist public bodies in responding to the new standards, the Heads of Treasuries Accounting and Reporting Advisory Committee (HOTARAC) has established a working party to examine the application and implications of the new international standards applying to the public sector in Australia. This Office will continue to monitor these developments and provide bulletins on a timely basis to assist public bodies in Victoria adapt to any change that new standards will require.

Audit independence has been in the headlines recently following a number of corporate collapses. This newsletter also contains a broad outline of developments. I would like to acknowledge the contribution of the Auditor-General of Queensland to this article.

Wayne Cameron  
*Auditor-General*

# AUSTRALASIAN COUNCIL OF PUBLIC ACCOUNTS COMMITTEES CONFERENCE

The Auditor-General, Wayne Cameron, and Deputy Auditor-General, Edward Hay, were delighted to be able to attend the 7<sup>th</sup> Biennial Conference of the Australasian Council of Public Accounts Committee (ACPAC) hosted by the Victorian Public Accounts and Estimates Committee in Melbourne from 2 to 5 February 2003.

The title of the Conference was “Emerging issues for Public Accounts Committees and similar type Committees”. In addition to representatives from parliamentary committees, governments, audit offices and academia from across Australasia, the Conference attracted a wide range of overseas participants.

The Conference program addressed many contemporary developments in resource management and accountability in the public sector, including public-private partnerships, governance, risk management, output-based budgeting and protecting the public interest in the 21<sup>st</sup> century.

Wayne Cameron presented a paper at the Conference on the changing relationship between Public Accounts Committees and Officers of Parliament, including Auditors-General.

## AUSTRALASIAN COUNCIL OF AUDITORS-GENERAL CONFERENCE

The ACPAC Conference (mentioned above) provided an excellent foundation for the Australasian Council of Auditors-General Conference 2003 which was hosted by Wayne Cameron on 6 to 7 February 2003, in Melbourne. In addition to Auditors-General from across Australasia, we were honoured to have present 4 international guests:

- John Noseworthy, Auditor-General of Newfoundland and Labrador, Canada;
- Fanuel Tjingaete, Auditor-General of Namibia;
- Walter Barth, Deputy Auditor-General of Namibia; and
- Michael Whitehouse, Assistant Auditor-General, UK National Audit Office.

Two external presentations formed part of the proceedings of the Conference. Ian Little, Secretary, Department of Treasury and Finance, spoke on “Contemporary features of Victoria’s financial management framework” and Ian Mackintosh, Chair of the Public Sector Committee of the International Federation of Accountants, provided “An international perspective on public sector accountability trends”.

We were very appreciative of the time given to the Conference by these 2 esteemed speakers.



*Auditor-General of Victoria, Wayne Cameron, (front, centre) hosted the 2003 Australasian Council of Auditors-General Conference in Melbourne, in February.*

## RECENT REPORTS TABLED IN PARLIAMENT

### **Report on Public Sector Agencies, February 2003**

This report sets out the results of financial statement audits for public sector agencies with 30 June 2002 balance dates, and the outcomes of a number of special reviews.

The audit results for the 30 June 2002 audit round indicated that:

- Scope remains for improvement in the timeliness of completion of audited financial statements, with only 40 per cent of entities meeting the 12-week legislative time frame - an outcome that was similar to that achieved for the previous audit cycle;
- A total of 429 audit opinions were issued on the financial statements of agencies with 30 June 2002 balance dates, with 22 qualified opinions issued, relating to such issues as inappropriate disclosure of grants, failure to consolidate controlled entities and failure to revalue assets; and

- While the majority of public sector agencies had maintained effective internal controls over financial and information technology systems necessary for the preparation of their annual financial reports, opportunities did exist for agencies to improve the effectiveness of their management and internal control processes. Among the significant issues identified were inadequate audit committee arrangements, absence of effective risk management arrangements, inadequate asset management practices and deficiencies in information technology management arrangements.

The report also included the results of a number of special reviews, including:

- Cash management at schools;
- Implementation of RMIT University's academic management system;
- Austin and Repatriation Medical Centre redevelopment, and Mercy Hospital for Women relocation project;
- Financial viability of hospitals;
- Public housing rental arrears and waiting lists;
- Provision of a uniform rate rebate by Glen Eira City Council;
- Former Delatite Shire Council – Management of involvement in the Lakeside Community Centre Project; and
- Status of the Docklands development, including the Victoria Harbour Precinct and Film and Television Studio developments.



*Aerial view of Victoria Harbour Precinct.*

## Control and compliance audits – Payroll management and Administration of the goods and services tax, March 2003

The Auditor-General has decided to expand the focus on providing assurance to Parliament on the performance of agencies in complying with key legislative requirements and maintaining appropriate governance and financial management practices through targeted control and compliance audits. The report on *Payroll management and Administration of the goods and services tax* outlined the findings associated with the first of these audits.



Overall, we found that payroll was effectively managed in the agencies reviewed. However, opportunities were identified in several agencies to strengthen payroll management through implementation of a range of additional controls and processes to reduce the risk of errors and to strengthen the level of monitoring of payroll expenditure by agency management.

In relation to the administration of the goods and services tax (GST), we identified that government departments had devoted significant attention to implementing systems and practices to manage this new taxation requirement. Despite this action, scope remained for additional clarification of the treatment of certain GST transactions and for additional training of staff in GST requirements to ensure errors in GST processing were minimised.

We identified a number of better practices operating within agencies for both payroll and GST administration. Adoption of these better practices by other public sector agencies would lead to overall improvements in the management of these activities.

## Drug education in government schools, March 2003

In 1996 the Victorian Government launched a comprehensive drug reform strategy called *Turning the Tide* that addressed drug education, legislative reform, and treatment and rehabilitation.

The overall objective of the *Turning the Tide in schools* initiative was to enhance and sustain drug education in Victorian schools to contribute to the minimisation of the harm associated with drug use by young people.

Since 1996-97, *Turning the Tide in schools* has resulted in almost all government schools and many non-government schools establishing school drug education strategies, providing teachers with professional development in drug education, the development of curriculum materials, and providing information and education programs for parents.

This audit also found that *Turning the Tide in schools* has successfully increased the amount and quality of drug education provided, particularly in government schools. The program has also facilitated the development of a range of student wellbeing initiatives.



*Core teams consulted widely to identify drug education issues in their school and local community. (Photograph courtesy of the Department of Education and Training.)*

As drug education moves from being a discrete initiative to a mainstream activity, the Department of Education and Training will need to ensure that drug education continues in schools, remains consistent and relevant to students and local communities, and is evaluated to improve its efficiency and effectiveness.

The audit makes 11 recommendations. These seek improvements in the implementation of individual school drug education strategies, the quality of drug education in schools, and the monitoring and evaluation activities undertaken by the Department and individual schools.

## Managing risk across the public sector, March 2003

Risk management is an explicit business management tool used to identify, evaluate and manage both risk and opportunity in a systematic way. Increasingly, risk management is being applied across all parts of the public sector, frequently with a formal approach.

In Victoria, key drivers for implementing risk management strategies include the *Victorian Managed Insurance Authority Act 1996*, the *Financial Management Act 1994*, the Government's Management Reform Program and policies associated with private-public programs such as Partnerships Victoria.

The report investigated risk management in the Victorian public sector by:

- examining risk management across a representative sample of 61 Victorian public sector organisations with a range of organisational and governance arrangements;
- an examination of risk management structures and processes at a State-sector level; and
- detailed risk management case studies.

The results show that while most Victorian public sector organisations are addressing risk management in some way, risk management is not yet an established or mature business discipline. Approximately one-third do not explicitly identify and assess their key risks; nor do they always report risk information to key stakeholders. More thorough assessment and measurement of all risks, and risk treatments, is required at both organisational and State-sector levels.



*Surgeons in the operating theatre at Sunshine Hospital. (Photograph courtesy of Western Health.)*

The audit found that there is a lack of clarity around the responsibility for the escalation of State-sector risks and a lack of a full understanding of these risks across a portfolio. Consequently, certain risk types could go undetected at a State-sector level and insufficient risk mitigation strategies could be implemented from a whole-of-State perspective.

The recommendations relate to having a consistent and rigorous approach to risk across the public sector, appropriate to the organisation's level of risk.

### **Managing medical equipment in public hospitals, March 2003**

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This audit assessed the efficiency and effectiveness of the management, maintenance and replacement of 2 groups of medical equipment in 19 of the State's 91 public hospitals. The 2 groups comprised 5 of the most costly (major) items (e.g. computed tomography scanners) and those items used for the treatment of 3 common conditions: heart attack, chest pain and hip replacement (e.g. infusion pumps). A total of 4 310 items were examined, including the condition and life expectancy of each item.



*A computed tomography (CAT) scanner.*

The audit concluded that the equipment examined was well maintained, although a high proportion was beyond its life expectancy. Only about 3 per cent of the equipment was in "poor" condition and needed to be replaced immediately, at an estimated cost of \$10 million. A further 14 per cent was in "fair" condition and needed to be replaced by 2005, at an estimated cost of \$32 million.

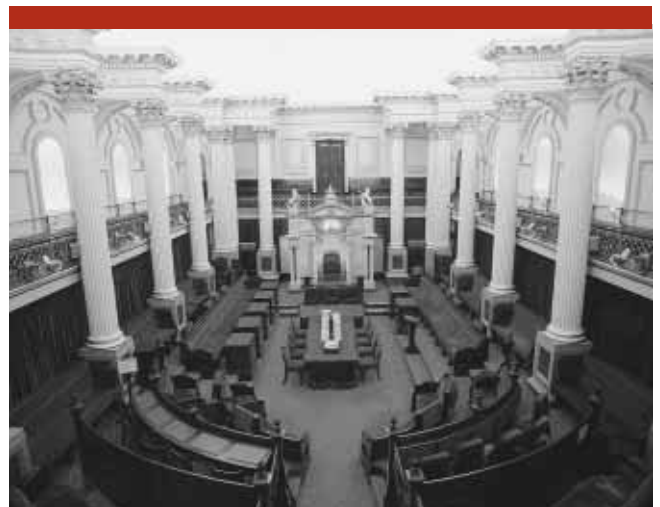
Hospitals need to develop asset management plans and identify their funding requirements beyond a 12-month period, preferably to at least 5 years ahead. The Department of Human Services also needs to develop a strategic framework for managing medical equipment. Unless these actions occur, there is a real risk that hospitals may not have sufficient funds to replace equipment as and when required.

The 19 hospitals and the Department of Human Services accepted the results of the audit and most of its recommendations.

### **Parliamentary control and management of appropriations, April 2003**

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The wide-ranging reforms that have been implemented over recent years to the State's financial management and accountability framework have significantly impacted on resource management and accountability within the Victorian public sector, including the parliamentary appropriation arrangements. In the context of these reforms, this audit examined the legislative and administrative arrangements associated with parliamentary appropriations to assess whether Parliament's interests are being protected, and whether there is scope for improvement in the administration of appropriations.



*Parliament plays a key role in control and scrutiny over public finances.*

The report identifies that the ultimate impact of successive reforms to the State's financial management and accountability framework has been that Parliament has provided the Executive Government with substantial discretion over the spending of taxpayers' funds. Substantial scope remains to strengthen the associated scrutiny and accountability arrangements so as to facilitate effective transparency and accountability to Parliament over public spending. Some of the key areas identified for parliamentary and executive government consideration included:

- the operation of "global" departmental appropriations;
- the operation and availability of various legislative budget management mechanisms (such as annotated receipts, carry-forward of unused appropriations, appropriation transfers etc.), including the associated reporting arrangements;
- parliamentary scrutiny and oversight of budget estimates and outcomes, including the role of the Public Accounts and Estimates Committee in the parliamentary budget consideration process, and the quality of the *ex-ante* information available to Parliament related to departmental and other public sector agency operations and performance expectations;
- administrative arrangements for appropriations, including the quality of output performance measures and the related assurance processes over key information systems;
- the administration of the Treasurer's Advance, including the need to more clearly define its purpose; and
- the scope of Trust Fund operations and the associated financial report disclosures.

The report provides the opportunity for Parliament to reassess how well it is placed to discharge its key role of exercising effective control and scrutiny over public finances, and holding the Executive Government to account. It also outlines various opportunities available to the Executive to enhance the administration of appropriations, and the associated reporting and accountability arrangements.

### **Performance management and reporting: Progress report and a case study, April 2003**

Victoria's Performance Management and Reporting Framework is designed to improve public sector performance and accountability by aligning the resource allocation process with the Government's environmental, social and economic policy objectives.

Since December 1999, the Auditor-General has had a mandate to audit the relevance, appropriateness and fair presentation of performance indicators published in the annual reports of public sector agencies. This Office has placed its early focus on the adequacy of the Framework and accompanying performance indicators, prior to exercising its mandate to audit the indicators themselves.

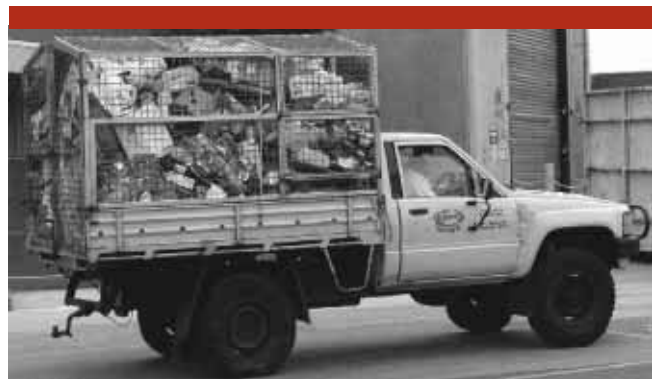
This is the third report by this Office on the status of the Framework and we are still some way from being in a position to subject performance information to the rigours of a full attest audit.

The Framework in its current form has a number of key deficiencies, namely:

- there is a range of government outcomes – many of which are core government business – which are not included as part of the Framework;
- the Framework covers departments only and does not incorporate all public sector agencies contributing to the broad range of government outcomes;
- there is no requirement for public sector agencies to include agency objectives and related performance indicators under the *Financial Management Act 1994*; and
- the Government has yet to finalise the format and structure of whole-of-government reporting.

In order to enhance the Framework, a reporting system that revolves around policy objectives at ministerial portfolio level could provide more precise linkages between government outcomes and the outputs contained in the *Budget Papers*.

The audit also contained a case study in the waste management sector which found that few of the agencies reported performance information. There is also an absence of sector-wide reporting standards, guidelines and protocols.



*Effective waste management involves fostering practices which lead to the generation of less waste and encouraging the recycling of discarded material.*

The recommendations of the audit relate to improving the content and structure of the Framework, and the roles of public sector and central agencies in this regard. In addition, a key recommendation involves the waste management sector working collaboratively to develop the necessary reporting standards, protocol and guidance statements.

## Report on Public Sector Agencies – Results of Special Reviews, May 2003

This report on public sector agencies outlined the findings of a number of special reviews of various activities across government and within specific agencies. Reviews included in the report were:

- The Criminal Justice Enhancement Program administered by the Department of Justice;
- The Asset Confiscation Scheme administered within the Justice portfolio;
- The operation of the Regional Infrastructure Development Fund by the Department of Innovation, Industry and Regional Development;
- Outsourcing of IT services by Victoria Police;
- Status of the Federation Square development;
- Administration of study assistance by government departments;
- Internet security management;
- The State Library Development;
- Control over drugs and poisons in public sector agencies; and
- Redevelopment of the driver licensing system by VicRoads.



*Federation Square, Melbourne, viewed from Swanston Street.*

Several key findings were included in the report with many aimed at improving the effectiveness of governance, management and accountability practices in the subject areas.

## Fire prevention and preparedness, May 2003

The combination of climate, topography and vegetation mean that southern Australia is one of the most wildfire-prone regions in the world. Fire is an inevitable part of the Victorian ecology, and effective planning for a response to periodic outbreaks of fire is necessary for the protection of life and property.



*Safe conduct of fuel reduction burning requires trained staff and expert supervision.*

Fire prevention and preparedness in country Victoria is the responsibility of 2 key agencies – the Country Fire Authority (CFA), which is responsible for prevention and response on private land, and the Department of Sustainability and Environment (DSE), which is responsible for fire prevention and suppression in Victoria's 7.7 million hectares of public land. Local government and industry bodies such as rail and power authorities also have important responsibilities for fire prevention.

The audit reported that improvements have been made in rural fire prevention and preparedness since the Auditor-General's previous audit of fire prevention on public lands in 1992, and since the tragic death of 5 firefighters in the Linton fire of 1998.

Areas of strength include: strategic planning for a joint approach by the CFA and the DSE; implementation of a nationally and internationally recognised incident control system; the DSE's risk-based resource allocation model and the CFA's community education programs.

Areas identified as requiring further work include: the completion of a Statewide fire safety strategy by the Office of the Emergency Services Commissioner; planning for fire prevention within local government; strategic management of hazard reduction on public land by the DSE; and the development of risk-based resource allocation models within the CFA.

The audit makes 47 recommendations. These seek to build on the progress made to date and to target key areas for future.

# AUDITOR INDEPENDENCE<sup>1</sup>

Auditor independence has been in the headlines for much of the last 2 years following the corporate collapses of a number of Australian and American companies.

The issue of auditor independence continues to be discussed because of the important role auditors play in providing the users of financial reports with assurance about the contents of those reports. Independent external audits give assurance about the reliability, credibility and integrity of financial reports. When there is a perception that auditors are not independent, confidence is reduced.

The Commonwealth Parliament, the Commonwealth Government and the accounting profession have spent considerable time and effort in addressing the concerns that have emerged from these corporate collapses. This article focuses on the outcome of these reviews.

While the corporate collapses occurred in the private sector, the principles of effective corporate governance, including auditor independence, is just as relevant to the public sector.

The Auditor-General of Queensland in the March edition of the *Inform* magazine (Issue 10) also comprehensively addressed the issue of auditor independence, and we would like to acknowledge the contribution of the Auditor-General of Queensland to this article.

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Over the last few years, several major corporate failures, both in Australia and internationally, have heightened the extent of public interest in auditor independence.

The most significant corporate failures in Australia include high profile corporations such as Pasminco Ltd, Ansett Australia, One.Tel Ltd, Impulse Airlines Ltd, Harris Scarfe Holdings Ltd, Franklins and HIH Insurance Ltd<sup>2</sup>. Internationally, Xerox Corporation, Sunbeam Corporation, Enron and WorldCom have also been in the headlines.

A brief summary of some of the factors involved with the collapse of HIH Insurance Ltd and Enron follows.

## **HIH Insurance Ltd**

HIH entered into voluntary administration in March 2001. Some of the accounting and auditing issues that may have led to the voluntary administration of HIH include:

- The auditors adjusted figures after meetings with HIH directors. Losses from HIH's Lloyd's business in London were revised down from \$40 million to \$9 million. In addition, the auditors suggested that net assets should be written-down by \$100 million, but the adjustment made was \$57 million by the time the final report was prepared<sup>3</sup>;

- The auditors held "reasonable suspicions" of HIH's insolvency, but did not communicate this to HIH directors prior to the eventual demise. In their defence, the auditors stated that a lack of financial details were provided by HIH, that management accounts for HIH's subsidiaries did not exist and, hence, a firm conclusion could not be reached<sup>4</sup>; and
- The HIH Chairman was also a member of HIH's audit committee and former senior partner of HIH's external auditor<sup>5</sup>.

## **Enron**

Alleged accounting and audit issues included:

- off-balance sheet entities were omitted from Enron's consolidated financial statements;
- failure to consolidate investments in Chewco investments, a related party that invested in Joint Energy Developments Investments Limited Partnership (JEDI), and JEDI resulted in Enron understating debt by \$2.585 billion between 1997 and 2000; and
- failure to consolidate JEDI, Chewco and LGM Limited partnerships resulted in Enron overstating net income by \$591 million between 1997 and 2000<sup>6</sup>.

These cases emphasise that independence is a crucial element in auditing as it pervades all levels of the audit function, and directly affects audit quality and perceptions about the integrity and objectivity of the auditing profession.

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## **What is audit independence?**

Statement of Auditing Practice 32 (AUP32) indicates that audit independence "requires a freedom from bias, personal interest, prior commitment to an interest, or susceptibility to undue influence or pressure, any of which could lead to a belief that the audit opinion was determined other than by reference to the facts of the audit alone"<sup>7</sup>.

The corporate failures of the past few years have put the audit profession, and its role, under the spotlight. The vulnerability of the audit process and inherent risks associated with the lack of audit independence have prompted public and private sector organisations to reassess the relationships between management and the auditor and, most importantly, the perceived need by both auditors and boards to demonstrate a high level of independence.

In response, both in Australia and internationally, the issue of audit independence has been subject to renewed interest by governments and the accounting profession.

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<sup>1</sup> The use of information published by the Queensland Audit Office in its *Inform* magazine, Issue 10 (March 2003) is greatly appreciated. Issue 10 can be found at [www.qao.qld.gov.au](http://www.qao.qld.gov.au)

<sup>2</sup> Joint Committee of Public Accounts and Audit (2002), *Review of Independent Auditing by Registered Company Auditors*, [www.aph.gov.au](http://www.aph.gov.au) p. 2.

<sup>3</sup> A Hepworth (2001), "Accountants adjust HIH figures", *Australian Financial Review*, 20 December 2001, p. 5.

<sup>4</sup> D Humphries (2001), "Ernst questioned on HIH solvency silence", *Sydney Morning Herald*, 20 December 2001, p. 25.

<sup>5</sup> A Backover (2002), "Australia investigates Andersen link: Auditor's client seeks bankruptcy protection", *USA Today*, 28 January 2002.

<sup>6</sup> CPA Australia (2000) – Far North Queensland Branch (2002), "*Accounting and Audit Update*" Country Congress, 23 August 2002, pp. 40-1.

<sup>7</sup> CPA Australia (2002), AUP32: *Audit Independence*, paragraph 8.

## International developments

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The International Federation of Accountants (IFAC) has produced model guidance on which national accountancy ethics should be based. Section 8 of the *Code of Ethics for Professional Accountants* contains the international community's rules on professional independence<sup>8</sup>. The Code advocates a move to a conceptual framework approach requiring the identification and evaluation of threats to independence and the application of safeguards to reduce any identified threats to an acceptable level.

Following the dramatic collapses of Enron and WorldCom, the US responded quickly with *Sarbanes-Oxley Act 2002*. This Act represents major governance reforms for companies whose securities are quoted on the US securities markets, or who have filed registration documents with the SEC. Major governance changes included:

- Accountants are prohibited from providing specified additional services to audit clients, including legal services, financial information systems design, fairness opinions and expert services unrelated to audit;
- Internal control reports which state management's responsibility for establishing and maintaining an adequate internal control structure must be included in annual reports;
- Companies are required to establish audit committees consisting entirely of independent directors within 270 days of 30 July 2002<sup>9</sup>;
- Some audit committee oversight functions have been prescribed, including taking responsibility for the appointment, compensation and oversight of the company's auditor, who must report directly to the committee, and establishing procedures to receive and deal with complaints relating to the company's accounting and audit processes, including those raised anonymously by employees; and
- Some services by auditors are banned by the Act, including for example, internal audit outsourcing services, and management and human resource functions. The Act also requires that other services are only provided with the prior approval of the audit committee; audit partners are rotated every 5 years; and no audit services are to be performed by an audit firm if the company's CEO, CFO or other senior financial staff was employed by the audit firm in the year preceding the audit<sup>10</sup>.

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<sup>8</sup> International Federation of Accountants (2001), IFAC Code for Professional Accountants, [www.ifac.org](http://www.ifac.org), 16 January 2002.

<sup>9</sup> *Sarbanes-Oxley* at a glance, Corporate Finance, September 2002.

<sup>10</sup> C Hughes and F Castiglia, "Wall Street Blues – US Government Reforms and their Australian Echo", *Australian Corporate News*, CCH Australia, 2 October 2002.

## Australian developments

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The major roles associated with the auditor independence framework include:

- the professional accounting bodies through their professional requirements and codes of ethics;
- the Australian Securities and Investments Commission through its enforcement of the provisions of the *Corporations Act 2001* which relate to auditor independence; and
- public sector auditors subject to legislation enacted by each jurisdiction that establishes and protects the independence of Auditors-General and their staff.

As a response to the increasing public scrutiny of auditor independence, various initiatives have been adopted or recommended by the accounting profession and accounting standard-setters. These initiatives are aimed at ensuring that auditors maintain their independence, and protecting and further enhancing the reliability and integrity of the financial reporting process. Australian standard regulators have introduced several amendments to the existing framework governing the work of auditors to restore public confidence.

The accounting profession in Australia produced a revised *Professional Statement F1 – Professional Independence of the Code of Professional Conduct* (revised Statement F1). Although not required to be adopted until 31 December 2003, the Government, through the Corporate Law Economic Reform Program (CLERP) has responded with proposals that revised Statement F1 be effective immediately.

Revised Statement F1 largely adopts the IFAC approach and the following table details threats to independence and circumstances creating those threats.

<i>Independence threat</i>	<i>Circumstances creating threat</i>
<p><b>Self-interest</b></p> <p>Where a firm or member of the assurance team could benefit from a financial interest or other self-interest conflict with an assurance client.</p>	<ul style="list-style-type: none"> <li>• A direct financial interest or material indirect financial interest in an assurance client;</li> <li>• A loan or guarantee to or from an assurance client or any of its directors or offices;</li> <li>• Undue dependence on total fees from an assurance client;</li> <li>• Concern about the possibility of losing the engagement;</li> <li>• Having a close business relationship with an assurance client;</li> <li>• Potential employment with an assurance client; and</li> <li>• Contingent fees relating to assurance engagements.</li> </ul>
<p><b>Self-review</b></p> <p>When any product or judgement of a previous assurance engagement or non-assurance engagement:</p> <ul style="list-style-type: none"> <li>• needs to be re-evaluated in reaching conclusions on the assurance engagement; or</li> <li>• a member of the assurance team was previously a director or officer of the assurance client; or</li> <li>• was an employee in a position to affect the subject matter of the assurance engagement.</li> </ul>	<ul style="list-style-type: none"> <li>• A member of the assurance team being, or having recently been, a director or officer of the assurance client;</li> <li>• A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement;</li> <li>• Performing services for an assurance client that directly affect the subject of the assurance engagement; and</li> <li>• Preparation of original data used to generate a financial report or preparation of other records that are the subject matter of the assurance engagement.</li> </ul>
<p><b>Advocacy</b></p> <p>When a firm, or a member of the assurance team, becomes an advocate for or against an assurance client's position or opinion to the point that objectivity is, or is perceived to be, impaired.</p>	<ul style="list-style-type: none"> <li>• Dealing in, or being a promoter of, shares or other securities in an assurance client; and</li> <li>• Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.</li> </ul>
<p><b>Familiarity</b></p> <p>When, by virtue of a close relationship with an assurance client, its directors, or officers/employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.</p>	<ul style="list-style-type: none"> <li>• A member of the assurance team having an immediate family member or close family member who is a director or officer of the assurance client;</li> <li>• A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement;</li> <li>• A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement;</li> <li>• Long association of a senior member of the assurance team with the assurance client; and</li> <li>• Acceptance of gifts or hospitality, unless the value is clearly insignificant, from the assurance client, its directors, officers or employees.</li> </ul>

<i>Independence threat</i>	<i>Circumstances creating threat</i>
<p><b>Intimidation</b></p> <p>When a member of the assurance team may be deterred from acting objectively and exercising professional scepticism by threats actual or perceived, from the directors, officers/employees of an assurance client.</p>	<ul style="list-style-type: none"> <li>• Threat of replacement over a disagreement with the application of an accounting principle; and</li> <li>• Pressure to reduce inappropriately the extent of work performed in order to reduce fees.</li> </ul>

Revised F1 applies safeguards to 3 areas:

- Those created by the profession, legislation or regulation. These relate to areas such as education, training and professional standards, as well as promoting external reviews of the organisation's quality control system;
- Those within the audit client. These are aimed at ensuring that appropriate governance structures, policies and procedures are in place to facilitate the independence of the external auditor; and
- Those within the audit organisation's own systems and procedures. These are aimed at creating an environment, within the organisation, which promotes and supports independence, and apply to areas such as leadership, policies and procedures, and communications. At the engagement level, the safeguards are aimed at enhancing transparency of the engagement, disclosures to the client's audit committee and removing perceived or actual conflicts of interest.

The revised F1 can be accessed at [www.cpaaustralia.com.au](http://www.cpaaustralia.com.au)

## Australian reform

In 2001 and 2002, the findings of 3 reviews were released which play a critical role in establishing the future framework for auditor independence. These are:

- *Report on Independence of Australian Company Auditors (Ramsay Report) (October 2001);*
- *Corporate Disclosure: Strengthening the Financial Reporting Framework (CLERP 9 policy paper) (September 2002); and*
- *Review of Independent Auditing by Registered Company Auditors (Joint Committee of Public Accounts and Audit) (September 2002).*

While these reports focused on the private sector, the principles of independence highlighted in the reports equally apply to the public sector. An overview of each follows.

### ***Report on Independence of Australian Company Auditors (Ramsay Report) (October 2001)***

The Ramsay Report marked a turning point in audit independence and related issues in Australia. The report identified 4 main relationships, which must be considered in determining whether auditors were independent of their clients. These are detailed in the following table.

<i>Relationship</i>	<i>Core circumstances which threaten independence</i>
<p><b>Employment relationship</b></p> <p>Employment by client of current auditor/employee of auditor.</p> <p>Employment by client of certain relatives of auditor.</p>	<p>An auditor is not independent if a current partner or employee of the audit firm is:</p> <ul style="list-style-type: none"> <li>• an officer of the client;</li> <li>• a partner, employer or employee of an officer of the client; or</li> <li>• a partner/employee of an employee of an officer of the client.</li> </ul> <p>An auditor is not independent if an immediate family member of a member of the audit engagement team is:</p> <ul style="list-style-type: none"> <li>• a director of the client; or</li> <li>• an officer or employee of the client who can influence the audit engagement.</li> </ul>

Relationship	Core circumstances which threaten independence
<p><b>Employment relationship – cont.</b></p> <p>Employment by a client of former auditor/employee of auditor.</p> <p>Retired audit partner joining board of audit client.</p> <p>Employment by audit firm of former employee of client.</p> <p>Remuneration from audit firm.</p>	<p>An auditor is not independent if a former partner or professional employee of an audit firm is:</p> <ul style="list-style-type: none"> <li>• a director of the client; or</li> <li>• an officer or employee of the client who can influence the audit engagement;</li> </ul> <p>unless the individual:</p> <ul style="list-style-type: none"> <li>• does not influence the audit firm’s operations or financial policies and does not participate or appear to participate in the audit firm’s business or professional activities;</li> <li>• has no capital balances in the audit firm; and</li> <li>• has no financial arrangement with the audit firm other than one providing for regular payment of a fixed pre-determined dollar amount not dependent on the revenue, profits or earnings of the firm.</li> </ul> <p>An auditor is not independent if a former partner of an audit firm who was directly involved in the audit of a client becomes a director of the client within a period of 2 years of resigning as partner of the audit firm.</p> <p>An auditor is not independent if a member of the audit engagement team has, during the period covered by the audit report, been:</p> <ul style="list-style-type: none"> <li>• an officer of the client; or</li> <li>• an employee of the client in a position to influence an audit engagement.</li> </ul> <p>An auditor is not independent if an officer/employee of the client in a position to influence the audit engagement receives any remuneration from the audit firm for acting as a consultant to it.</p>
<p><b>Financial relationship</b></p> <p>Investments in audit clients.</p> <p>Loans to and from audit clients.</p>	<p>An auditor is not independent if:</p> <ul style="list-style-type: none"> <li>• the audit firm/any member of the audit team/his or her immediate family has a direct or a material indirect financial investment in the client; or</li> <li>• the audit firm has a material financial interest in an entity that has a controlling interest in the client; or</li> <li>• any other client service personnel or his or her immediate family has a direct or a material indirect financial interest in the client.</li> </ul> <p>An auditor is not independent if:</p> <ul style="list-style-type: none"> <li>• a partner of the audit firm or an entity which the partner controls, or a body corporate in which the partner has a substantial holding owes more than \$10 000 (or such other amount prescribed by regulation) to the client; or</li> <li>• the audit firm, any members of the audit team/any of his/her family members accepts or makes a loan to a client, or has a loan guaranteed by a client or guarantees a client’s loan.</li> </ul>

Relationship	Core circumstances which threaten independence
<p><b>Business relationship</b></p>	<p>An auditor is not independent if:</p> <ul style="list-style-type: none"> <li>• a member of the audit team has a business relationship with the client or any of its officers which is not clearly insignificant to both the member of the audit engagement team, and also the client or the officer; or</li> <li>• the audit firm has a business relationship with the client or any of its officers which is not clearly insignificant to both the audit firm and also the client or the officer.</li> </ul>
<p><b>Non-audit services</b></p> <p>Regulation of non-audit services.</p> <p>Disclosure of non-audit services.</p>	<p>Recommended that the regulation of non-audit services provided by auditors to audit clients be dealt with in professional ethical rules to reflect the IFAC proposals.</p> <p>Recommended that the financial report for the year must disclose:</p> <ul style="list-style-type: none"> <li>• the dollar amount of all non-audit services provided by the audit firm to the client, divided by category of service, with appropriate discussion of those services; and</li> <li>• whether the audit committee or board of directors (if audit committee does not exist) has considered whether the provision of non-audit services is compatible with maintaining the auditor's independence.</li> </ul>

The report also recommended that:

- an Auditor Independence Supervisory Board be established to play a role in ensuring public confidence in the independence of auditors by monitoring implementation of the new regime;
- ASX Listing Rules be amended to mandate the establishment of audit committees, specifying the composition of the committee and requiring the board of directors to adopt a written charter governing the committee;
- the auditor of a listed company should be appointed and remunerated by the audit committee;
- mandatory rotation of audit partners to occur after a maximum of 7 years, but may occur sooner if considered appropriate by those involved in the audit;
- the Corporations Act or the ASX Listing Rules or guidance note should be amended to ensure that a proposed change to the auditor of a disclosing entity is a continuous disclosure matter;
- the Corporations Act be amended to require the auditor or a representative of the auditor to attend the AGM of a listed company at which the auditor's report is tabled, unless reasonable circumstances preclude the auditor's attendance; and
- the Corporations Act should provide that any proposal for appointment of auditors of a disclosing entity must contain information on the proposed fees.

The report can be accessed at [www.treasury.gov.au](http://www.treasury.gov.au)

### **Corporate Law Economic Reform Program (CLERP)**

The Australian Government sought submissions to the Ramsay Report and CLERP 9 policy paper, *Corporate Disclosure: Strengthening the Financial Reporting Framework*, includes a government response to the Ramsay Report.

Reform proposals in CLERP 9 were wide-ranging. Of particular interest were the proposals in relation to audit quality, which encompassed auditor independence; non-audit services; audit committees and the attendance of the auditor at AGMs. CLERP 9 policy paper proposed that:

#### **Managing auditor independence**

- The Corporations Act will include a general statement of principle requiring the independence of external auditors;
- The Corporations Act will require external auditors to make an annual declaration of independence to the board of directors;
- Amendments to impose new restrictions on employment relationships between the external auditor and the audit client. This includes a 2-year mandatory period following the resignation from an audit firm before a former partner who was directly involved in the audit of a client can become a director of the client, or take a position with the client involving responsibility for fundamental management decisions;

- Amendments to impose new restrictions on financial relationships between the external auditor and the client. This will cover investments in audit clients and loans between an audit client, and the auditor or the auditor's immediate family; and
- The Government supports a series of measures to deal with non-audit services.

#### **Audit committees**

- Audit committees will be mandatory for the top 500 listed companies; and
- Audit partners rotation will be compulsory after 5 years. The new requirement will apply to the engagement and the review partner.

#### **Auditor attendance at AGMs**

- External auditors will be required to attend the AGM of listed companies and to respond to questions concerning the audit.

#### **Qualifications for registration as a company auditor**

- Accountants seeking registration as a company auditor will be required to meet agreed competency standards, to undertake to abide by an accepted code of professional ethics and to complete a special auditing course prior to registration.

#### **Auditor liability**

- The Government will seek the agreement of the States to introduce proportionate liability for auditors (replacing joint and several liability).

#### **Incorporation of audit firms**

- The law will be amended to allow auditors to operate through corporate structures.

### **Review of Independent Auditing by Registered Company Auditors, by the Joint Committee of Public Accounts and Audit**

In September 2002, the Joint Committee of Public Accounts and Audit released the above report and its recommendations included that the Corporations Law be amended:

- to require all publicly listed companies to have an audit committee of independent members;
- to require audit firms to report annually to ASIC on independence issues; and
- to include a general statement on audit independence.

The Committee recognised that better disclosure was required to improve the ability of the users of financial reports and the market in general, to understand the companies they invest in and, in particular, the risks associated with those investments. The Committee made a number of recommendations designed to promote more transparency and compel companies to enhance their governance arrangements.

## **Implications for the Victorian public sector**

### **Victorian Auditor-General's Office**

Public sector auditing differs from private sector auditing in a number of significant ways. The framework that governs the independence of the public sector auditor is enshrined in legislation that establishes the statutory position of Auditor-General and public sector functions.

In Victoria, the framework is based on the *Constitution Act 1975*, *Financial Management Act 1994* and the *Audit Act 1994* which protect the independence of the Auditor-General by establishing provisions which support the independence and transparency of the Auditor-General and the Office.

Specifically, these Acts include provisions that prescribe the appointment procedures, duties and responsibilities of the Auditor-General. They also prescribe that the Auditor-General:

- is the auditor of most public sector entities;
- may conduct an audit in the way the Auditor-General considers appropriate;
- is not subject to direction by any person about the way in which the Auditor-General's powers are to be exercised in relation to an audit and the priority to be given to audit matters (the Public Accounts and Estimates Committee of Parliament also has a role in the consideration of the Auditor-General's Annual Plan);
- has, for the purposes of conducting an audit, access to all documents and property;
- has the power to compel a person to produce documents;
- has the power to conduct financial statement and performance audits, and other inquiries and report to Parliament any matters which, in the Auditor-General's opinion, are significant;
- is required by legislation to determine whether there has been any waste of public resources, or any lack of probity or financial prudence; and
- must comply with the Australian Auditing Standards.

To further enhance the independence, the Act provides for the annual financial audit of the Office's financial statements and a performance audit every 3 years by a firm independently selected by the Public Accounts and Estimates Committee. The results of the financial audit are included in the Auditor-General's *Annual Report*, which is tabled in Parliament, and the results of the performance audit are also tabled in Parliament.

The legislative requirement that the Auditor-General report to Parliament is a key distinguishing feature of the audit independence framework between public and private sector auditors. It reinforces the principle that the primary client for the conduct of audits is Parliament, and provides an open and direct reporting relationship that facilitates audit independence.

The private sector has no such equivalent.

### ***Public sector bodies***

Effective governance arrangements assist organisational transparency and accountability. Audit committees in particular are valuable mechanisms for facilitating auditor independence. Part 8 of the Directions of the Minister for Finance require that Accountable Officers establish and maintain an audit committee to oversee and advise him or her on matters of accountability, and internal control affecting the operations of the department. The guidelines note that non-departmental members are highly desirable as they are not involved in the day-to-day operations of the department.

While these Directions apply to departments, they provide persuasive guidance of better practice for all public sector bodies.

The Department of Treasury and Finance is currently reviewing the Directions with a view to issuing revised Directions shortly covering all public sector agencies. The draft Directions establish a governance framework for the public sector that includes the establishment of audit committees.

## **How does the Victorian Auditor-General's Office safeguard the independence of its audit activities?**

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The Office applies a range of measures designed to maintain the independence and credibility of its audit activities, many of which have been in place since the late 1990s. Details of these measures are described below.

### ***Quality assurance review process***

An integral part of quality control within the Victorian Auditor-General's Office is the program of reviews of a sample of completed financial audits. The objectives of the program are to assess whether audits have been undertaken in accordance with auditing standards established by the profession.

The quality assurance process also works to ensure that the auditing process maintained sufficient independence and objectivity, and assists the Auditor-General to fulfil his role of keeping Parliament and the public informed on matters of public interest.

Each year, quality assurance reviews, referred to as "cold reviews", are conducted of a sample of audits covering at least one audit for most audit service providers and audit directors across all sectors. The process provides feedback on the outcome of each review. The results also inform decisions about future work the auditor may undertake on behalf of the Auditor-General.

### ***Adherence to auditing standards***

Financial audits undertaken on behalf of the Auditor-General are to be conducted in accordance with Australian Auditing Standards issued by CPA Australia and the Institute of Chartered Accountants in Australia (ICAA), the requirements outlined in the Office's Financial Audit Policy Manual and any guidelines issued from time-to-time by the Auditor-General.

### ***Policy on conflict of interest***

It is important that the independence of the external audit process not be called into question as a result of actual, perceived or potential conflicts of interest. Such conflicts could arise when members of a firm of an audit service provider perform non-audit services for an agency for which the audit service provider has been appointed. Audit service providers are required to avoid all situations that establish or have the potential to establish a conflict of interest, or the appearance of a conflict of interest.

While audit service providers and/or their firms are constantly in demand to provide accounting or consulting work for public sector agencies, particularly given the extent of commercialisation of government services, they are not to accept such work unless the audit service provider has the prior written approval of the Auditor-General. Types of services which have the potential to give rise to a conflict include:

- internal audit, asset valuation, taxation and actuarial services;
- accounting policy advice;

- services relating to the establishment, preparation and/or maintenance of accounting records and systems;
- the preparation of financial and other accountability statements; and
- any other services related to fundamental aspects of the client's business and/or strategic planning.

Audit service providers may, however, carry out added assurance work as agreed with the Auditor-General from time-to-time.

### ***Declaration of interests***

The Office applies the *Code of Conduct for the Victorian Public Sector* to its staff. The Code provides, among other things, guidance for addressing ethical issues, such as conflicts of interest and confidentiality in the use of official information.

In accordance with the Code, all senior staff and any other employee assessed by the Auditor-General as warranting a declaration on the basis of potential conflict complete a Declaration of Pecuniary Interests. Declarations are updated and signed every 12 months.

### ***Five year rotation policy***

Commencing with new contracts in 2001, the Office introduced a policy requiring the mandatory rotation of audit service providers and directors after a maximum of 5 years. The policy restricts auditors from re-applying for audits after this period, however, another auditor from the same firm remains eligible to tender for the audit thereafter.

### ***Financial auditing brochure***

In order to broaden awareness of the Auditor-General's approach to financial auditing, the Office has available a brochure summarising the key aspects of the audit process and the Office's approach to the resourcing of audits.



### ***Further information***

If you would like further information about matters raised concerning auditor independence, the following websites are worth visiting:

[www.treasury.gov.au](http://www.treasury.gov.au) CLERP and the Ramsay Report

[www.aph.gov.au](http://www.aph.gov.au) Joint Committee of Public Accounts and Audit

[www.cpaaustralia.com.au](http://www.cpaaustralia.com.au) Professional Statement F1

[www.dtf.vic.gov.au](http://www.dtf.vic.gov.au) Financial Management Package

[www.audit.vic.gov.au](http://www.audit.vic.gov.au)

[www.qao.qld.gov.au](http://www.qao.qld.gov.au)

[www.anao.gov.au](http://www.anao.gov.au)

## FURTHER INFORMATION



AUDITOR GENERAL  
VICTORIA

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