

# Internal Audit in NSW Local Government

## Submission from the Audit Office of New South Wales on the Department of Local Government Discussion Paper August 2005

### Establishing and maintaining effective internal audit for local government

Currently, legislation provides only a limited role for the Audit Office in relation to local Councils. In that context, we had limited opportunity to respond to the alarming findings reported by the Independent Commission Against Corruption (ICAC) in 2001 about the generally parlous condition of the internal audit function across the local government sector.

However, we were involved with supporting and assisting the initiative of the Institute of Internal Auditors (IIA) in writing to your Minister in 2003, seeking action to raise the standard of internal audit to that in other jurisdictions.

In organisations for which we have responsibility for the external audit function, we place considerable emphasis on the need for a properly functioning audit committee and internal audit function. It is a key aspect of the governance, risk and control framework that we need to assess in determining our external audit scope and focus. Effective internal audit may allow us to place reliance on some of the work undertaken internally, reducing external audit efforts (and fees).

While it has taken a very long time since the issue was highlighted (by ICAC, and subsequently the IIA), we are very pleased to see the Department's 2005 initiative of issuing a Discussion Paper.

We fully support the reform of internal audit in the local government sector to best practice levels.

Going forward, having established internal audit at appropriate levels, maintaining the function is a key issue. We believe that ongoing benchmarking should be undertaken against other jurisdictions, with the results publicly reported by the Department.

We appreciate that achieving a consistent and enduring standard for internal audit across the sector is a task for which the Department may seek support from external audit. We note that the IIA has advised your Minister that internal audit is stronger in Victoria and Queensland, where the Auditor-General is responsible for the external audit function in local government. This is also the case in national systems such as New Zealand and the United Kingdom. The IIA regards such arrangements as best practice and has recommended that arrangements in NSW be changed accordingly.

While we have not actively sought to change the current policy on this issue, we would support such a change were it to be proposed.

## Legislation, Standards, Guidelines and Charters (and the issue of small councils)

We consider that an internal audit function should be a mandatory requirement for all councils, and should be supported by legislative provisions similar to those that exist for NSW State Government agencies under the Public Finance and Audit Act 1983, with which you are familiar.

We acknowledge that practical difficulties exist for small councils. We encounter similar situations for very small agencies in the State sector. For that sector, this has been addressed in two ways. Firstly, the legislative requirement does not specify the form through which the internal audit function need be delivered. Outsourced, co-sourced or shared-service arrangements would satisfy the legislative requirement. Secondly, recognising that some agencies may be too small to attract a service provider from the market, the NSW government created the Internal Audit Bureau as a provider of internal audit services with that specific purpose. It operates as a business unit of the NSW Treasury.

The Department could initiate discussions with NSW Treasury to expand the coverage of the Bureau to include councils, or could look towards establishing a similar arrangement itself.

Sector-specific Standards for internal audit are not critical in our view. As a matter of principle, we would refer to the professional Standards issued by the IIA.

We do not consider that internal audit guidelines should be developed on a council-by-council basis. However, sector-specific guidelines may be helpful in tailoring arrangements to suit the environment. We have reviewed the Victorian Guidelines and consider them to be sound.

Charters are required for each Council on the specifics of internal audit functioning at that organisation. This allows for tailoring at the detailed functional level to suit local structures and arrangements. The Audit Committee should have responsibility for approving the Charter, and regularly reviewing it and updating it.

However, to provide a consistent standard of internal audit across the sector, we believe that the Department should develop a "model charter" for internal audit, as has been done in Victoria. Local audit committees would need to explain material variations in their local charter against the model.

### Internal Audit Reporting

Your Discussion Paper suggests that standard arrangements for internal audit reporting lines cannot be replicated for Councils (ie. reporting to an audit committee). Your Discussion Paper emphasises the separation of powers between the elected Council and the general manager, arguing that internal audit is an operational matter and section 335(1) of the Local Government Act would not allow an arrangement where internal audit took directions from a council committee.

Instead, you propose an arrangement whereby the Council would hold the General Manager accountable through his or her employment contract for establishing an effective internal audit function. This arrangement would equate to the relationship between a Minister and a chief executive of a NSW Government Department under the Public Finance and Audit Act.

It is not an unworkable arrangement. However, there are grounds for suggesting that the accountability relationship between the elected Council body and the council organisation should be more direct. Whilst an elected council is not a board in the usual corporate sense, its existence necessarily differentiates it from the model under which a department of state operates.

Elected councils are not supreme. They in turn have accountability to a government Minister. This is demonstrated most clearly when elected councils have been dismissed by the Minister, for reasons including poor performance. This suggests that the Council should take direct responsibility for performance, in a way not dissimilar to a board.

Because of this, in our view a link is required between internal audit and the elected council body. Logically, this link would be achieved through an audit committee, as occurs both in Queensland and Victoria (albeit via different approaches to the composition for their audit committees). We have examined the Victorian Guidelines and observe that the issue which concerns you appears to have been satisfactorily resolved.

The Victorian arrangements allow for internal audit to report directly to the chief executive, who has functional responsibility for the internal audit function. This addresses the requirements of your legislation. In addition, the Victorian Guidelines specify that internal audit will also report to the audit committee, and that the audit committee will fulfil essentially all of the normal functions in overseeing the internal audit function (including approving the internal audit work program).

We consider that the provisions for internal audit set out in the Victorian Guidelines are a viable approach to resolving the reporting and accountability issues that you raised in the Discussion Paper.

One further point should be added. Situations where internal audit may be investigating actions by a chief executive present a potential for a conflict of duty.

This is another reason why an audit committee is essential, and why audit committees should not include chief executives as members. Some points about council audit committees are provided below. However, in terms of reporting lines for internal audit, we consider that guidelines should establish that internal audit will report to the audit committee on all audit-related matters, and also to the CEO except where this may involve a conflict of duty: in which case reporting to the audit committee should take precedence.

### **Audit Committees**

We consider that an audit committee should be a mandatory requirement for all councils.

Extensive material is available on current best practice for audit committees. The IIA and the Australian National Audit Office (ANAO) have produced excellent material on this issue. We would also draw particular attention to the recommendations of the NSW Public Accounts Committee Report No. 11/53 (154) of April 2005 on this subject.

We acknowledge your experience of how Councils work in practice, and your emphasis on the separation of powers between the elected Council and the general manager. However, the Victorian Guidelines make it clear that the audit committee is there to support sound decision making and financial management by Council, not to usurp Council nor to direct management.

Based on the discussion in the previous section, and our experience with audit and accountability arrangements, we recommend a different approach to the audit committee than the one your Discussion Paper is proposing. We believe that an audit committee should have a more involved role with internal audit than your Discussion Paper suggests. We support the approach adopted in the Victorian Guidelines, including the model charter. In those guidelines the audit committee's role is very specific.

To fulfil such a role, the audit requires specific skills of its members, rather than necessarily being composed of a large number of members reflecting a wide range of views.

One of two options in Queensland for the composition of a council audit committee is for all members of the committee to be elected councillors (this could be called a "board committee model"). This may have advantages for specific knowledge of local arrangements and processes. But it also has potential disadvantages of not achieving the required technical skills and knowledge required to perform the roles required. The body of elected councillors may not necessarily possess these skills, as they are not a requirement for election to council. This is the reason for the second option available in Queensland, where the audit committee comprises representative/s of the elected council as well as independent external members selected for their specific skills (this could be called an "advisory committee" model).

The Victorian Guidelines have opted for the advisory committee model, which we also support because the skill requirement factor is central to the ability of the committee to perform its role effectively.

Particular aspects of the Victorian approach to audit committees that we strongly recommend be adopted for the NSW local government sector are:

- the audit committee operate as an independent advisory committee to Council
- the audit committee comprise a minimum of three members - one Councillor and two external independent persons
- the committee chair be appointed by the committee from the external members of the committee, with the appointment subject to Council's approval
- the managing director not be a member of the audit committee, but should attend all meetings (except any held in-camera)
- the internal auditor should attend all meetings (except any held in-camera)
- committees greater than three persons must be composed of a majority of external independent members
- all members have full voting rights
- the external auditor be invited to attend meetings at the discretion of the committee, but must attend meetings considering the draft annual financial report and the results of the external audit
- a periodic review of audit committee effectiveness is essential. Annual is suggested. This can be done as a self-assessment using best-practice checklists.

## **Governance and Risk Management**

In contemplating an improved level of internal audit for the local government sector, we would highlight the significant role for internal audit as an integral partner in improving governance and the management of risk, often in conjunction with other units or functions within the organisation.

There are a variety of ways in which internal audit can contribute towards this vital area of governance. The IIA can assist with an array of guidance material on this issue. However, two examples that may be of assistance at this early stage of your considerations are:

- Risk Management, Issue 19, July 2005 ([www.riskmanagementmagazine.com.au](http://www.riskmanagementmagazine.com.au)), provides an article (pages 18-19) about Penrith Council's approach to the Australian Stock Exchange's Principle 7 (self assessment of directors and senior management) as part of improving corporate governance

- Internal Auditor, August 2005 ([www.theiia.org](http://www.theiia.org)) provides an article (pages 97-101) about Brisbane City Council's approach to aligning internal audit's risk based approach to audit planning to the risk management framework for the whole Council.

#### **Internal audit models, arrangements, support and quality assurance**

The Annual Report of each Council should highlight the role of internal audit as an essential element of good governance.

At a functional level, in our view the greatest single element supporting effective internal audit is the creation of an audit committee with an independent chair.

Finding the right operating model for internal audit is an issue for the audit committee to examine. Internal units, co-sourcing, outsourcing, and shared services are all viable possibilities. The test of adequacy comes when arrangements for internal audit are:

- independently reviewed, through means such as:
- external audit (such as the ANAO has done in the Commonwealth)
- professional quality assurance reviews (now required once every 5 years under the IIA's Professional Standards Framework)
- tested against industry benchmarks (such as the IIA's GAIN benchmarking facility).

Such elements of ongoing assurance should thus be built into the framework for implementing internal audit in the local government sector.