A U S T R A L I A N N A T I O N A L A U D I T O F F I C E

Address to the Institute of Internal Auditors, Canberra

Audit Committee – Roles and Responsibilities

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I. Introduction

The Institute is to be commended for making this opportunity for all of us to reflect on the roles and responsibilities of Audit Committees particularly at this time when the replacement legislation for the existing Audit Act appears imminent. However, there is also other relevant legislation such as the Public Service Bill, the Charter of Budget Honesty and the requirements for Public Service Charters relating to service delivery which reinforce the emphasis on management performance and accountability and relations with stakeholders and citizens as clients or customers.

The first part of this address looks at the responsibilities of agency management under the proposed legislation. The second briefly examines the application of corporate governance principles to the emerging environment. The main part of the address discusses various aspects of the roles and responsibilities of Audit Committees including their independence and relationships to both internal and external audit.

II. Managing in the New Legislative Environment

The proposed legislative changes to the framework of public administration are part of much more wide-ranging public sector reforms which bear on the nature of public administration; methods of delivery of public services, including by the private sector; organisation and people management; and accountability for performance. The focus is very much on leadership and responsibility. They are highly pertinent topics to the times.

The proposed financial management and accountability legislation provides an apparently unambiguous statement of the 'duties' of those persons and bodies who 'govern' each agency. For example, if we consider the special responsibilities of chief executives of agencies covered by the Financial Management and Accountability (FMA) Bill, we can appreciate that the implications flowing from these 'duties' are profound and very demanding. The requirements under the Commonwealth Authorities and Companies (CAC) Bill on Directors are equally demanding.

The overarching requirement of chief executives of FMA agencies is ***'management of the affairs of the Agency in a way that promotes proper use of Commonwealth resources for which they are responsible'***. Other more specific responsibilities include:

- implementation of a fraud control plan;

- establishing and maintaining an audit committee;
- pursuing the recovery of debts;
- maintaining accounts and records; and
- providing periodic financial statements as required.

'***Management** of the affairs of the Agency in a way that **promotes**…*' clearly connotes the ***leadership*** role of the Chief Executive Officer (CEO). This encapsulates the need to identify, develop and direct strategy and to monitor performance. Consequently there is a very real <u>personal</u> responsibility for Commonwealth resources used and controlled by their Agency. There are clear elements of ***stewardship*** implicit in this. The CEO has a duty of care to the providers of those resources (viz. the taxpayers who are represented by the Parliament). The CEO is bound to protect and reinforce the rights of these stakeholders on whose behalf he or she employs ***their*** resources to produce required results.

One criterion against which the effectiveness of these ***stewardship and leadership*** roles is measured is the '***proper use'*** of resources. The legislation requires the *'efficient, effective and ethical'* use of resources. The primary mechanism through which the CEO can be assured that this responsibility has been and continues to be fulfilled is commonly referred to as the agency's ***control structure*.** This term encompasses a number of inter-related elements including the **control environment** and **internal control systems and procedures**; the agency's **information and communication** systems; its **risk management strategy** and internal **monitoring and review** systems and processes.

The proposed three replacement Acts for the current *Audit Act 1901* will be strongly complemented by the proposed new Public Service Act. The following comments by Mr Reith, the then Minister assisting the Prime Minister for the Public Service, in his Second Reading Speech on the *Public Service Bill 1997* reinforce the foregoing observations:

> 'This Bill considerably enhances accountability. It acknowledges and protects the public interest as never before. It considerably improves Parliamentary scrutiny of the way the Australian Public Service undertakes its delegated responsibilities on behalf of Government. It recognises, and protects, the distinctive ethos of public administration. It provides a foundation for a Service in which actions and decisions are open and transparent.'[1]

III. Applying Corporate Governance Principles

The triumvirate of stewardship, leadership and control are part of the wider concept of ‘corporate governance’ — a concept which has been receiving some attention recently in the public sector. I hope you have had an opportunity to read the ANAO’s recent discussion paper on the ‘Principles for Core Public Sector Corporate Governance’[2]. The concept has its roots in the private sector and, in particular, relates to the legal, fiduciary and ethical responsibilities of the directors of public companies acting individually and collectively as a ‘governing board’. If we replace the term ‘governing board’ with the term ‘governing body’, and understand that the Chief Executive of an FMA agency is the ‘governing body’, the linkages between the sectors become clearer.

In this sense it can be argued that the principles of corporate governance in the private sector should be able to be translated into equivalent principles for public sector governance in most respects. There are of course some important differences in the two governance models which need to be understood before we embark on any discussion of the current and future roles of the public sector audit committee.

The foremost difference, in relation to FMA agencies, is that the governing body and the chief executive officer are one and the same. The Chief Executive of an FMA agency therefore has a range of responsibilities and accountabilities which, in the private sector, are commonly divided between an ‘independent’ board and the executive management of the corporation. In this respect I note that the CEOs of a number of public sector agencies have established an executive board of management to assist in carrying out a range of corporate governance functions. Nevertheless the final responsibility remains with the individual CEO who is directly accountable to the relevant Minister.

It is also clear that Ministers do not assume the role of the ‘Board of Directors’ or executive management for FMA agencies. They are regarded as accountable to the Parliament for the programs and agencies under their control even though the definition and interpretation of such accountability has been subject to considerable public debate over a long period. They do represent shareholders’ interests sometimes in a quite direct manner and often with the legislative power to give instructions to, say, Boards of Government Business Enterprises (GBEs). The Parliament represents shareholders’ interests in a less direct but quite compelling manner. Their emphasis is on accountability which means transparency and openness to a far greater degree than provided in the private sector.

The option of creating an ‘independent’ governing body simply does not exist within an FMA agency. This in turn has important implications for the governance structures that are appropriate to, and effective, within such bodies. Nevertheless there is considerable scope for the application of corporate governance principles to enhance the performance and accountability of public sector agencies. The most important requirement and strength of those principles is to ensure integration of all the various elements on the governance model to focus on agency accountability, performance, conduct and relationships with stakeholders.

IV. The Role of the Public Sector Audit Committee

I now turn to the role of the public sector audit committee. That role has been seen in the context of the new legislative framework and as an important element of corporate governance. The committee could be said to have a 'guide dog' role in relation to the effective operation of corporate governance within an agency. As well, the Committee should at least provide assurance about the overall control environment and the financial reporting of the agency.

A Question of Independence

Much of the content of this address has been drawn from the ANAO Better Practice Guide on Audit Committees which we published in July last as part of a Financial and Administration Control (FCA) Audit[3]. I understand there are a number of copies of the Guide available here this morning.

Looking at the private sector audit committee we find increasingly that there is a premium being placed on its independence and that this independence is regarded as a benchmark of good corporate governance. The audit committee, being a sub-committee of the Board is mostly, if not wholly, comprised of non-executive directors. It is an instrument of the Board and acts for and on behalf of the Board in the areas it has been mandated to oversight. I use the term 'oversight' advisedly—the committee does not, and should not, have any executive power in its own right. It cannot diminish in any way the individual and collective responsibility of any of the directors.

This model translates fairly readily to those Commonwealth agencies which are entities for the purposes of the proposed Commonwealth Authorities and Companies (CAC) Act. These bodies, most with some form of external board, comprising at least some members who are not a part of executive management, have the capacity to establish an independent committee. For this reason I will not dwell too much on the roles and responsibilities of such committees as there are any number of resources and widely published models which deal with these issues based on private sector practices and experience. Nevertheless, consideration has to be given to the inherent differences between the public and private sectors not least in relation to issues of values, ethical conduct and public accountability. Entities are public sector organisations operating largely in a commercial 'private sector' fashion not the other way around.

The same observations cannot be made about audit committees in FMA agencies, for the reasons given earlier. Some have questioned whether an 'independent' audit committee (generally meaning members from outside the agency) is really necessary for, and can actually contribute much to, the governance of such agencies. Supplementary questions that arise, if the response is in the affirmative, are how to ensure that independence is achieved in practice and what is their role in the governance model. An even more pragmatic view recognises the accountable nature of the public sector and simply reflects on what can be undertaken to provide the level of assurance required under the new legislation. While there will be differences across agencies reflecting the diversity of the public sector, I suggest we can be more ambitious and confident than the latter view would suggest. There is a very real problem of dealing with an external <u>perception</u> of effectiveness which is often related to the <u>perceived</u> degree of actual independence.

The effectiveness of the Committee is, in my view, a function of the corporate governance model within which it operates—in this regard I am a pragmatist. You cannot make the committee into something which is not appropriate to the particular governance model. Imagine for the moment that we simply translated the private sector model into an FMA agency. This would have us establish a committee with no members who are part of executive management—in other words with members who have no direct interest in or accountability for the agency's functions and programs.

This situation would be the equivalent of having a private sector audit committee comprised of members who are neither directors or management—in other words 'outsiders' with no 'ownership' of the organisation's objectives, strategies and performance. While the <u>dis</u>interest of such members may be considered laudable, there is a question as to their commitment to the organisation, their effectiveness and the responsibility assumed. Would it simply be a case of 'all care and no responsibility'? To be fair, there are examples where one could not doubt the commitment of those involved. Nevertheless, there are inherent limitations with such membership. The conundrum is to effect the appropriate balance between credible authority and independence. It does not have to be one <u>or</u> the other.

It would seem desirable that the Committee should be comprised mainly of members who have some kind of stewardship relationship with the entity. In an FMA agency this would be the chief executive and/or the executive management group. Therefore, as a practical issue, it could be said that the quality of independence is likely to be strained (apologies to the Bard) for an FMA agency. If this view is accepted, it naturally follows that we should examine the appropriate powers and functions for a committee which is not wholly 'independent'. In essence this means considering the powers and functions of a 'management-based' audit committee with perhaps some 'outside' representation to at least challenge the 'insiders'' views. I note that less than 30 per cent of agencies currently have at least one external member on their audit committee. In a recent address to an Australian Taxation Office Staff Conference, I made the following point about management members of the Committee:

> 'The clear imperative for them, which should be reinforced by the CEO, is that their membership is as informed and independent contributors not as representatives of their particular areas of responsibility'.[4]

The powers of a 'traditional' audit committee centre on its right of access to information and explanation. This covers matters such as the power to call on any employee to attend a meeting and supply information, as requested. It also extends to the power to engage consultants at the expense of the agency as the committee deems necessary. The level of representation and good sense of the committee, as well as its own accountability for performance, should ensure that there is not an unnecessary budget impact.

Such powers are essential if the Committee is to operate effectively. Their importance should be reinforced by being explicitly set out in a formal, approved Charter. This 'protection' is particularly important for an 'independent' committee comprised of members external to the management of the entity. However, it may be argued that these powers are less important for a management-based committee as many, if not all, of the members will possess these or equivalent powers within their own operational and management responsibilities. Nevertheless, the adoption of a Charter is considered good practice. It also is a vehicle for raising awareness of the role and importance of the committee in the organisation generally.

The issues of the powers of individual committee members in their management capacity and in their committee role are worth exploring a little further. The ANAO accepts the likelihood that an agency will generally not have a perceived fully 'independent' Committee membership. The Chief Executive, with his or her Executive Board if one exists, will need to decide the shape of the Committee and to determine what powers it should have. On the other hand, if it is decided that the Committee should mirror as closely as possible the private sector and CAC agency models, the

Chief Executive will need to ensure that the members, **in their capacity as members**, have no executive or decision-making powers and no supervisory responsibilities.

It would no doubt be argued that the above approach should make it easier for the members to clarify in their own minds their roles and responsibilities as committee members and hence to act objectively when considering the results of audits and when providing advice to the Chief Executive. However, for most agencies, identification of suitable available membership under <u>such</u> conditions would be quite difficult. The issue is basically how to achieve the 'right balance' of attributes that match the assessed requirements, particularly for accountability, by each agency.

Of course it is totally within the remit of the Chief Executive to provide the Committee with decision-making powers—to delegate his/her functions and powers. In this situation, however, there is a blurring of the role of the audit committee (as traditionally viewed) compared to that of any other management committee. As well, the CEO does not delegate his or her ultimate responsibility and accountability. Consequently such role blurring and the uncertain messages it conveys to the rest of the agency would indicate that this approach is not good practice. This observation also suggests to me that it is undesirable for the CEO to chair the Committee as the final decision - maker and the one legally responsible for managing the agency.

Relationship of an Audit Committee to Internal Audit

Given that a Chief Executive has decided to establish an audit committee and provide it with appropriate powers, it is necessary to consider what relationship it should establish with the Internal Audit function for it to be fully effective.

Historically, audit committees in the public sector have focussed on Internal Audit. Our recent audit confirmed that this continues to be the case. Over 90 per cent of all public sector audit committees (whether outsider or management-based) indicated they took an active role in relation to Internal Audit including:

- approving strategic and annual work plans;
- reviewing progress against plan;
- reviewing internal audit reports and management responses; and
- following up the implementation of internal audit recommendations.

The importance of this element of a committee's functions is also anticipated by the proposed Finance Minister's Orders to be issued under the FMA legislation which prescribe these activities in the new legislative context.

The fact that a Committee is management-based also does not appear to be a hindrance to its effectiveness in this area. It is more likely for example that for a sufficiently large committee (say around five members) there will be members who are not directly subject to particular internal audit reports and who can therefore be seen to be clearly objective in their deliberations. Outside membership would provide a similar level of assurance.

In my view the synergy created through the interaction between the audit committee and internal audit is something which has to be carefully guarded and nurtured by the committee in its oversighting role. There needs to be mutual trust and confidence and a clear understanding of each other's role and functions. In short, a partnership should be established. I would hope that the same notion would apply to the external auditor.

As I have said on a number of occasions, including in an address to your Annual Directors' Forum here in Canberra in 1995[5], internal audit is a key management control facility. By virtue of its position within an organisation and its relationship with the executive of the organisation, Internal Audit is well placed to make a significant contribution to the development and implementation within an agency of the many public sector reforms referred to at the outset of this address. In saying this, I am well aware of the small agency problem in this respect which I will canvass shortly.

I commented in 1995 that "it [Internal Audit] carries with it a responsibility to maintain a working understanding of the whole of the public sector reform agenda"[6]. To be able to do this, the function must have adequate resources. Those resources should not be simply diverted to non-audit duties as particular management priorities may dictate. In particular, their independence needs to be maintained. Those imperatives underline the authority and credibility of the function within the agency.

The audit committee is the key player in monitoring these features and should act as a bulwark against the temptation for decisions about resource use priorities to degrade the effectiveness of the internal audit function. In this respect the committee very much has a stewardship role to play. By the same token, the internal audit group has to deliver quality, timely and cost effective products which are valued both by the committee and management at <u>all</u> levels of the agency.

One issue of particular interest that an audit committee has to, at least, consider in relation to Internal Audit is that of outsourcing which I have already canvassed in broad terms. The counter-point to maintaining adequate resources within the agency is that these resources should have the skills and knowledge necessary to fulfil the roles set out by the chief executive for internal audit. This is also a management responsibility under any Personal Development Program.

As with the external audit function the necessary skill sets and knowledge requirements are varied and complex and rarely reside wholly within one individual or even a small number of people. This can be a major factor impinging on the effectiveness of small internal audit sections typically found in the smaller agencies. A particular problem is to attract suitable candidates at the levels necessary to be credible both to potential recruits and to those with whom they would be working. As well, there is the difficulty of maintaining professional expertise with little or no peer contact.

Outsourcing, in whole or in part, provides a mechanism whereby a small agency with a small internal audit resource base can access the skill sets and knowledge it needs at a reasonable cost, particularly in a rapidly changing environment. Such outsourcing could, of course, be done with a ‘parent’ portfolio agency. Unfortunately, in my view, this has not generally been seriously considered. There are potential benefits for both parties. On the other hand, you may be interested in the following comment made by the New South Wales Auditor-General in an audit late last year referring to the conduct of the internal audit function:

> ‘Any economies of scale through shared audit management were felt to be less important than a close unambiguous relationship with one Board and one management team.’[7]

The audit committee in such agencies may wish to consider the outsourcing option to ensure greater effectiveness of the function. The ANAO’s survey of audit committees and internal audit in 1995 indicated that most small agencies have in fact already outsourced their internal audit activities. One concern is that this action should not be seen as also outsourcing management’s responsibility, in particular if the outsourcing is quite narrowly focussed, say, on financial statement preparation or even on an ad hoc systems control assurance assignment.

The issue is perhaps less clear for larger agencies which require a comparatively larger internal audit resource base and are therefore more likely to be able to attract and retain the necessary skills and knowledge within the agency. As well, the internal audit function does not have to be narrowly focussed and should be able to contribute to the establishment of a sound framework of accountability within the agency; provide greater assurance on the control environment, including fraud control plans and ex-ante as well as ex-post reviews; and assist in the implementation of effective risk management approaches incorporating risk assessment, analysis, prioritisation and monitoring of performance.

Consideration of outsourcing the whole or a part of internal audit's activities must then venture beyond narrow capability deficiencies. The Committee needs to consider the strategic importance of the internal audit function and the potential for an outsourced arrangement to impact on its effectiveness.

As suggested above, in my view internal audit should have a deep appreciation of the current and proposed public sector reforms, particularly in the area of financial management and administration. Executive management would like to think that personnel engaged in the internal audit function have a real commitment to, and ownership of, the organisation's objectives, values and code of conduct. I would also like to see a commitment to public service and a well developed sense, and understanding, of public accountability.

The ability of an outsourced internal audit cell to possess this knowledge of the implications of public sector reforms and of the organisational intricacies and complexities of the agency and its programs is surely diminished without at least some first-hand day to day exposure to the business/functions. The latter could be provided by a complementary in-house oversighting capability. The latter should have the confidence of management to be able to identify, articulate and provide credible agency-based approaches and practices to fulfil its accountability obligations and enhance its overall performance. Again, it is a question of establishing the 'right balance' to meet the corporate governance needs of the agency. I would observe that it is essential for any contracted auditors to acquire a good understanding not only of the agency's business but also of the changing public service environment if they are to be effective.

I suggest that the audit committee of a large organisation, if satisfied that it is reasonably viable to retain the necessary expertise in-house, would need to give very careful consideration to any proposal for outsourcing simply on some hourly cost basis or on experience with a narrowly-oriented audit task. Assessment of cost effectiveness should start with realistic identification of agency risks and a hard-headed analysis of what an efficient internal audit function could do to assist in effectively managing those risks. No doubt this assessment would require an element of judgement which should be made clear.

One area worth examining is whether outsourcing is taken as an opportunity for a disguised down-sizing. In such a situation the committee should seek comfort that management have taken appropriate action to replace any resulting reduction in compliance and monitoring activities with other appropriate alternative measures. The issue is simply about effectiveness and the overall performance of the agency.

Unfortunately, history has shown that agencies have rated activities such as training, evaluation and internal audits as of lower priority in resourcing decisions. Hopefully this is now seen as counter-cultural to the reform movement over recent years.

Audit Committee Relations with External Audit

It was pleasing to see in our recent FCA audit that the majority of audit committees have now established a relationship with the external auditor. However, the rate at which this is taking place is somewhat lower than in relation to internal audit. The fostering of closer relationships between audit committees and my Office is one of our major business objectives. From my perspective, our financial statement and performance audit activities and the responsibilities of the audit committee, as they relate to providing the Chief executive with assurance, naturally complement each other.

While I welcome the opportunities being provided to invite ANAO auditors to meetings of the Audit Committees, membership is potentially a conflict of interest and sends the wrong signals to the various stakeholders. In a number of cases we have taken an observer role which provides some discretion to both parties about ANAO attendance at committee meetings.

The external auditor is a source of independent, professional advice in relation to accounting and auditing issues. Audit committee members should seek to exploit this knowledge where possible, particularly to augment their own understanding of key issues, not just in relation to the financial statements but also covering the underlying systems of control, asset management, accounts processing and other aspects of the accountability framework.

The audit committee is also best placed to ensure that the respective work programs of the external and internal auditor complement each other. This will ensure that the combined cost of the total audit activity is minimised and that the potential coverage is maximised. In addition, the Committee should take a high profile not only in developing the expertise and professionalism of the internal audit group but also contributing to any improvement in performance of the external audit.

The scope for a complementary relationship between internal and external audit arises, to a large extent, from similarities in the nature and scope of the work we undertake. In this regard we have a shared responsibility to understand the agency's business, the key business risks, and the internal control structures in place to address these risks.

The external auditor is of course solely responsible for the audit opinion and will make judgements on whether it is possible to rely upon the work of others in forming this opinion. There cannot of course be total reliance—however, the external auditor is generally able to place some reliance on the work of internal audit provided this work is relevant, undertaken by competent staff and subject to effective quality control procedures. The audit committee can have a significant impact on each of these criteria.

It is within management's prerogative to determine the scope and focus of internal audit activity. The Committee should seek to influence the strategic direction taken by internal audit and in doing so would consider the cost-effectiveness of using internal audit in this complementary role with external audit. In many agencies the Committee actually approves the Internal Audit program.

The Committee should take a strong interest in the qualifications and skill sets of staff in internal audit. I underlined the importance of this issue earlier. We recommend the Committee actively participate in the selection of the head of the internal audit function. The Committee should also seek assurances that the skills, knowledge and experience of internal audit staff are commensurate with the agreed strategic direction. The ANAO is prepared to include internal audit staff on its own professional development activities. This can have benefits for all parties.

As part of their annual review of internal audit the Committee would want to be assured that the quality control mechanisms established for internal audit work have been followed. In this regard the Committee may wish to consult with the external auditor and seek our views on particular aspects of internal audit. The ANAO management reports for financial statement audits would include comment as to the extent to which the external audit has been able to rely on the work of the internal audit in accordance with the anticipated level of planned reliance. Such an assessment is required under the auditing standards.

Before I leave the subject of the Committee's relationship with external audit and move on to other areas where audit committees are becoming increasingly active, I would like to touch on the Committee's role in relation to evaluation of the external audit function. It may at first seem odd to some that we recommended in our FCA report on Audit Committees that the Committee review the performance of the external auditor annually. It could be argued that this will achieve little where you do not have the ability to select the auditor of your choice. I can assure you the opposite is the case.

The ANAO does not take its mandate for granted. We act as if we are in a contestable environment. We recognise that feedback on our performance as the Commonwealth's external auditor is particularly useful not only to make improvements in that respect but also for our stakeholders, notably the Parliamentary Joint Committee of Public Accounts particularly when it is constituted as the Audit Committee of Parliament. An audit committee that takes an active role in the financial statement process and in considering external audit reports; one that has established a close working relationship, and developed a mutual trust with the external auditor; is, from our perspective, best placed to provide useful feedback.

I stress the value of the positive outcome from such an assessment and feedback for the agency in terms of improved client service and for the ANAO in terms of a more focused, cost-effective external audit process. These are the kinds of WIN-WIN situations we are endeavouring to achieve in all our audit work which meet our corporate vision to add value to public administration.

Developing Other Elements of the Committee's Role

The nature, size and complexity of an agency will largely dictate the role of an audit committee if the CEO is prepared to take a <u>broad</u> overview of that role as part of the development of an agency's accountability framework. Specifically, the FMOs referred to earlier foreshadow a particular role for the committee in relation to the financial statements of each agency. They provide that the Committee should review the financial statements before their submission to the Chief Executive for approval. This is an important initiative with implications for those managers signing off responsibility for their particular activities and their financial impacts.

Such a role is supported as it provides an opportunity for the Committee to engage with the external auditor to ensure that all significant business risks which may impact on the information presented within the statements have been addressed.

The FCA audit also showed that committees are gradually moving beyond the 'traditional' roles in relation to internal and external audit and the financial statements. This may bring us the full circle when we see that committees are more likely to concern themselves with the other elements of the control structure and to pursue stewardship issues which go to the heart of good corporate governance. For example, today's audit committees are venturing into the closely inter-related subjects of risk management and fraud control. They are likely to be oversighting the development and implementation of fraud control plans and risk management strategies. They are also likely to be taking on a monitoring role on behalf of the Chief Executive and will inquire into significant or unusual transactions that have taken place or have been proposed.

The challenge for an audit committee and CEOs is to ensure on-going support for the audit function to overcome what can only be described as variable effectiveness through variable support from top management. Unfortunately, in the past, we have tended to be reactive rather than proactive in the priority given to audit's role in the accountability framework.

Another area of committee interest and involvement is the ethical behaviour and conduct of agency personnel. In this regard the Committee could be the driver behind the development of codes of conduct and ethical pronouncements. They may also be the forum for review of ethical concerns and matters of improper conduct. Such involvement may achieve greater integration of important elements of corporate governance leading to a more effective governance framework.

How far the Committee moves along these newer paths is primarily a matter for the Chief Executive (or other governing body). We probably do not need reminding that change is now a constant in our lives. In this era of public sector reform, to be a member of an audit committee is not only a major challenge but presents itself as an opportunity to be at the forefront of the push to more effective corporate governance in all public sector agencies and, as a result, create a more highly performing and effective public service. That outcome is particularly important at this time for the confidence, morale, job satisfaction, commitment and professionalism of all public servants and our stature in the general community.

For my part, while often on the outside looking in, I can assure you that my Office will continue to be a dependable source of support and guidance for the public sector audit committees. Equally we will be looking for similar assistance in what should be a successful partnership and as a focus of our client service.

V. Concluding Remarks

The emerging public service environment involves risk elements in the change processes and in the external as well as internal delivery of services based on a more contestable and contractually-oriented, if not competitive, environment. We are being asked to adopt more private sector oriented approaches in order to improve our performance. One area where we do have lessons to learn is in corporate governance, in particular in bringing all the disparate elements of governance together in an integrated and cohesive whole. I suggest that an audit committee is not only an important part of that framework but it can also contribute greatly to the latter's integration in areas such as the control environment (including close liaison with internal and external audit), financial reporting, risk management and ethical behaviour, as well as the organisation's code of conduct.

The perceived and actual independence of an audit committee in a private sector corporation is an important part of its credibility and effectiveness. Brian Blood, a Partner with Arthur Andersen, quotes a survey conducted in 1994-95 as indicating that 85 per cent of Audit Committees with fewer than 6 members were comprised of non-executive directors[8]. For audit committees with 6 or more members the figure was 45 per cent. The Board/management situation is quite different to that in a public service agency and even in some entities. However, there are clearly direct parallels with most of the Government Business Enterprises. In my view, there is a need to keep a reasonable balance between stewardship and independence in order to gain the confidence and support of all stakeholders. This is a particular challenge for CEOs of agencies covered by the proposed FMA Act.

The Audit Committee's effectiveness depends a lot on the professionalism and contribution of the internal audit function. A real partnership needs to be created which I hope would extend to the external auditor. The Committee should be closely involved in setting the audit strategy and preferably, in my view, should in practice also approve the audit program. Of course, the CEO would need to endorse the Committee's approval.

The Committee should also endeavour to ensure that the function is appropriately resourced and that the professional and other skills required to undertake that program are available. This may involve decisions about partial or full outsourcing of the internal audit function, probably more so in small agencies. However, in larger agencies where recruitment, skills development and retention are not as significant an issue, committees would need to give weight to other factors such as knowledge and understanding of the business/functions and a real sense of ownership, commitment and, not least, loyalty to the agency and to serving the public. In any event contracted auditors should ensure they have a good understanding of the agencies' business and of the public sector environment and the ways in which it is changing if they are to provide a useful internal audit service.

In my view external audit should not have membership of an audit committee. There are potential conflicts of interest involved. Nevertheless I welcome the opportunity for observer status and interaction on issues of common interest. I stress that the issue is only about the nature of the interaction. Clearly, the ANAO should not be seen as part of an agency's management decision-making process. However, the Committee is a particularly apt focal point for our interaction with the agency which should make our audit activities that much more effective and assist the Committee in efficiently meeting the requirements of its Charter.

We are looking for a <u>real</u> partnership that has shared interests and shared goals even where there may be implicit or explicit criticism of the agency. The latter has to be seen as a challenge to both parties to take a positive approach in redressing any deficiencies and actively promoting, and contributing, as far as possible, to better agency performance. In essence, this is what we are all about. In saying that, I do not diminish the value to agency management or other stakeholders of a high level of assurance about the robustness of any accountability framework that has been put in place.

In conclusion, the positive reaction of many agencies already to the recent FCA audit on Audit Committees has been very gratifying. I take the opportunity to congratulate and thank not only the ANAO staff involved but also the many professionals in the various agencies who contributed to, what I consider to be, a landmark audit and a very useful Better Practice Guide that uses plain English and addresses the role of Audit Committees in a direct and practical fashion.

Thanks to senior Audit staff, and particularly Andrew Greaves, for helping me to put this paper together.

Notes and References

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2. Australian National Audit Office (ANAO) 1997. *'Principles for Core Public Sector Corporate Goverance'*. Discussion Paper, Canberra, June.

3. ANAO Paper No.39 of 1996-97. *'Audit Committees'* Financial Control and Administration Audit, AGPS, Canberra, June. (This report included an accompanying handbook designed to assist agencies and entities to establish an audit committee that will operate efficiently and effectively in accordance with currently acknowledged better practice principles.)

4. Barrett, Pat 1997 *'Internal Audit - Looking Ahead'*. Address to the Australian Taxation Office Staff Conference, Canberra, June (page 11).

5. Barrett, Pat 1995. *'Internal Audit : The Auditor-General's Perspectives'*. Address to the Institute of Internal Auditors. Annual Directors' Forum 1995. Canberra 31 October.

6. Ibid., (page 6).

7. Op. cit., *'Internal Audit - Looking Ahead'*. (page 18).

8. Blood Brian 1995 *'Audit Committees and Corporate Governance'*. ASCPA Congress 1995.