



Financial Sustainability Program

Information Paper 2
**An Overview of Audit
Mechanisms**

July, 2006



Introduction

This information paper is one of a number being developed as a part of the LGA’s Financial Sustainability Program. It is designed as a thought starter. Manuals, codes, guidelines, technical definitions, standards and similar documents are also being prepared to provide practical assistance to Councils.

The subject of this information paper is audit mechanisms. Recent amendments to the Local Government Act have introduced three relatively new concepts – a mandated requirement to have an audit committee, specific criteria regarding the appointment of auditors and a specific provision regarding the capacity for a Council to conduct an efficiency and economy audit. These are in addition to statutory responsibilities which Councils have for annual independent auditing of financial statements. This paper is aimed at ensuring a clear understanding of the differences between these mechanisms.

It should be noted that Councils are also subject to a range of external legislative requirements and powers in parallel with those applying to other governments including under the Criminal Law Consolidation, Freedom of Information, State Records and Ombudsman Acts.

This paper should be read in conjunction with the information papers on Financial Sustainability which highlight the increasing demands on Councils and the importance of efficiently managing the delivery of services. Information papers have been, or will soon be, prepared on the following topics:

- Financial Sustainability
- An Overview of Audit Mechanisms
- Audit Committees
- Scope of External Audits - Audit Specification
- Efficiency & Economy Audits
- Infrastructure and Asset Management (Policy and Planning)
- Service Delivery Framework including the Role of Shared Services
- Long-term Financial Plans
- Governance in Local Government
- Financial Governance and Management
- Revenue and Funding Policies
- A New Approach to Standards in Local Government
- A New Approach to State-Local Resourcing
- Depreciation
- Local Government Financial Indicators
- Debt Management
- An Approach to Assessing Financial Sustainability for Local Government

A number of manuals, guidelines, templates, technical definitions, codes, standards and similar documents supporting this series of information papers are also being prepared by the LGA to provide practical assistance to Councils.

For an update on which information papers have now been completed or information about other documents and activities, including briefing and training sessions, please visit our website at: www.lga.sa.gov.au/goto/fsp.

What is an audit?

The word "audit" means to check or review and is traditionally used in relation to formal and independent checking of financial statements. All Councils in South Australia have their accounts audited annually by a properly qualified private auditor – as required by the Local Government Act and in accordance with Australian Audit Standards. The auditor's report is published annually to communities (via Councils' annual reports) and provided to the SA Parliament.

Councils apply a range of controls to their finances, and operations in general, and often conduct reviews of projects or programs.

Financial management and reporting is integrated with the operation of Councils, as it should be, operating in parallel with strategic management planning and annual reporting provisions. Amendments to the Local Government Act in 2005 now require Councils to have long-term financial management plans and asset and infrastructure management plans integrated with strategic management plans.

Councils also have internal controls which "check" the existence or application of appropriate policies whether financial, legislative or risk management, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of accounting records and the timely preparation of reliable financial performance information. In some instances these are assisted by external consultancies (including some which have been prompted/brokered by the LGA). In most Councils the development of, and ensuring compliance with, such internal controls will be part of the role of one or more staff but are, except in one or two of the largest Councils, unlikely to be constructed as an "internal audit" function given the size of the organisations. In some instances Councils conduct reviews, with or without external consultancy assistance, and these often have a focus on efficiency and costs.

Increasingly governments and the private sector are adopting additional forms of auditing to provide a greater level of independent analysis of finances and related issues. In part this has arisen from high profile failures in the private sector but also from concerns in areas of the public sector.

Local Government aspires to the highest standards and while significant financial management problems have not been experienced by South Australian Councils, recent years have seen a questioning of Councils' performance in financial areas. The Financial Sustainability Inquiry was a substantive response to this questioning and it suggested a range of ways in which Councils can improve financial governance and financial information to ensure public confidence is maintained.

At the same time many Councils, by their own initiative, have worked to ensure they are meeting standards comparable with other sectors.

Why is auditing important?

Undertaking second or further checking of a task designated to be done once, particularly if done independently, is expensive. However in both the private and public sectors a range of tasks and functions are deemed important enough for such checking to be undertaken and in some instances to be mandated.

Independent auditing of financial accounts is the most common “checking” requirement as the accuracy of published accounts underpins substantial decisions by governments, private bodies and individuals.

The effectiveness of all spheres of government depends on public confidence and so government functions are often more open and the subject of more auditing and scrutiny than is experienced in the private sector. Often the nature of the functions of governments means that they have a wider impact on the community and a longer-lasting impact than the majority of private sector work. In addition it is public money that governments are responsible for managing.

Where does auditing fit into the governance and management of Councils?

The LGA published in 2001, a manual entitled “Finance – A Framework for Financial Management”. This document, which is being updated as a part of the LGA Financial Sustainability Program, described good financial management as the product of:

- *sound policy processes which achieve policy outcomes that are sustainable in the short and long term;*
- *extensive planning processes which ensure consideration of the broad range of options available to Councils; and*
- *accurate and reliable information for decision making. [Pp. 6&7]*

All three of these key elements are receiving attention as a result of the Inquiry and amendments in 2005 to the Local Government Act. This paper, and other more detailed information papers and tools, focus on the third area of “accurate and reliable information”.

The Local Government Act establishes a clear framework for democratically elected Councils, appointed skilled managers and staff and a strategic planning approach to focus decision making. All Councils have strategic management plans and soon all will be supported by long-term financial plans and infrastructure and asset management plans.

The Act provides clear role statements for Council Members and the Chief Executive Officer. Councillors have no powers individually but collectively have considerable power and responsibility, through formally established and open Council meetings. A Council’s role is to set policy and directions for the organisation and to review the performance of management in achieving objectives. The CEO and staff’s role is to carry out the decisions of their Council as efficiently and effectively as is possible and to provide sound policy advice and information to assist the Council in its decision making.

The Act provides for strategic management plans to be developed in consultation with communities. Through recent amendments to the Act, Councils’ annual plans and budgets also require consultation and must be contrasted with longer-term plans. Annual targets are to be set and must be reported on in Councils’ Annual Reports. In this way any Council observer – public, media or other governments, for example – can assess how a Council is performing against annual targets and against these long-term plans.

Internal and external review and audit approaches sit within this framework and are part of a coherent whole. None of the changes to the Act affect the basic framework of these systems.

It is well worth noting at this point that activity such as theft or corruption are dealt with in Local Government, in the same way as in State Government, with very severe penalties including prison terms for abuse. Internal controls, reviews and audit mechanisms interact with these systems where any such abuse is uncovered. Indeed such systems are often instrumental in exposing areas where such activity may be occurring.

In addition, Councils have regimes applying to conflict of interest and registers of interest for members and staff.

Internal Controls

Audit systems rely on good primary accounting systems and internal control. The newer provisions of the Act should not be viewed as alternatives to primary accounting systems or internal controls – indeed they are likely to demand higher levels of performance from those systems and controls. In 2002 the Local Government Financial Management Group, with funding from the Local Government Research and Development Scheme, published an “Internal Financial Controls – Best Practice Manual, 2002”. This manual is currently being reviewed as part of the LGA’s Financial Sustainability Program.

This document provides both an excellent framework for a best practice approach to internal controls in Local Government and a range of practical tools to assist in its implementation.

The Local Government Act requires Councils to keep proper accounting records (Section 124) to prepare financial statements (Section 127) and to maintain effective internal controls (Section 125).

Scope of External Audit

The Local Government Act makes specific provision for Councils to engage an independent auditor to undertake external annual auditing of financial statements (Sections 128 & 129).

The Financial Sustainability Inquiry raised issues regarding the lack of comparability and consistency in accounting approaches between Councils. Audits are not explicitly required to ensure consistency between Councils, but the Inquiry has highlighted a number of limitations for Councils as a result. The LGA has raised these with Councils and is employing several strategies to move towards greater consistency in approaches to auditing. The Inquiry recommended:

“That the LGA work with auditors, with input from offices such as that of the SA Auditor-General, to establish what might be described as a ‘model’ specification for a Council audit aimed at – in a manner consistent with Australian Accounting Standards – improving the consistency and comparability of accounting policies impacting upon the measurement of the key financial sustainability indicators, especially depreciation and other asset accounting policies.”

Information Paper 4: Scope of External Audit – Audit Specification addresses this issue and provides a model specification for Councils.

Audit Committees

The Local Government Act was amended in 2005 and now requires, at Section 126, that Councils form audit committees (previously this was discretionary).

Audit Committees provide a bridge between Councils, their managements and communities. They ensure that the accuracy and importance of an individual Council's financial statements receive a high level of attention. The principle functions and extent of authority for operation of audit committees are determined by Sections 126 and 41 of the Local Government Act respectively.

The functions of an Audit Committee, as specified in the Act, include:

- reviewing annual financial statements to ensure that they fairly present the state of affairs of a Council;
- proposing, and contributing relevant information to, a review of a Council's strategic management or annual business plans;
- proposing and reviewing the exercise of powers in relation to "other investigations" as specified under section 130A of the Local Government Act 1999 (e.g. the conduct of efficiency and economy audits - see Information Paper 5: Efficiency and Economy Audits);
- undertaking the functions that would have been undertaken by a (single Council) subsidiary's audit committee in cases where the Council has exempted the subsidiary from having an audit committee. (Note that this function has no application to a regional subsidiary.);
- liaising with the Council's auditors; and
- reviewing the adequacy of the Council's accounting, internal control, reporting and other financial management systems and practices on a regular basis.

The Act sets out provisions for the membership, terms of reference and operation of audit committees.

Audit committees have no authority to act independently of Councils but, in areas covered by their terms of reference, they may challenge management and the Council and make suggestions and recommendations for action considered to be in the best interests of an individual Council and its community.

For more information on the role of audit committees see Information Paper 3: Audit Committees.

Efficiency and Economy Audits

Council Members and management have an obligation to continuously review the efficiency and effectiveness of their Council's service delivery (Section 59 of the Local Government Act).

New Section 130A was inserted into the Local Government Act in 2005 and specifically enables Councils to commission an efficiency and economy audit and does not add substantially to the current power of Councils. However it does make Councils' powers explicit and perhaps gives them greater prominence.

Efficiency and economy audits are a thorough, rigorous and independent review of the acquisition and use of resources by Councils in specific programs or activities.

These audits may be commissioned on any matter relating to the manner in which an individual Council uses its resources to achieve its objectives and considered by the Council to be of such significance as to justify an examination. Councils may request their auditor or other suitably qualified person to undertake an efficiency and economy audit.

The primary interest of efficiency and economy audits is resource use rather than program effectiveness. An efficiency and economy audit will assess how the financial, material or human resources have been applied in a particular program or activity. The information gathered and examined in this audit will relate only to the activity being audited but will go beyond just the financial data.

Information Paper 5: Efficiency & Economy Audits provides more detail on the conduct of efficiency and economy audits.

What are the issues for Councils?

Understanding the various types of audits required or available to Councils under the Local Government Act is important for Council Members, CEOs and staff.

The various types of audits produce different information and outcomes for Councils and are designed to better understand and document financial governance practices and arrangements.

Public confidence in Councils is enhanced when there are systems, approaches and practices in place to monitor the efficient and effective use of public money against plans adopted to meet short and long term objectives, activities and service levels.

New and continuing Council Members must keep abreast of the requirements of the Local Government Act in relation to financial governance. CEOs and staff of Councils must put in place appropriate mechanisms to provide the necessary financial information for Members to monitor efficiency and effectiveness against financial and asset/infrastructure plans. Financial and other information should also be made available to external auditors or consultants engaged to assess the efficiency and effectiveness of Councils' operations.

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