



**Local Excellence**

Councils Working Together for Communities

*Financial Sustainability*

# Information Paper 2

## **An Overview of Audit Mechanisms**

Revised January 2012



## Introduction

This Information Paper is one of a series of Information Papers about Financial Sustainability and Financial Governance in Local Government.

The series of Information Papers was originally published in 2006 to 2011 as part of the Financial Sustainability Program. The history of that program and a complete list of Information Papers and other resources, including a glossary of terms and abbreviations, is provided on the LGA's "Financial Sustainability" web page: <http://www.lga.sa.gov.au/goto/fsp>.

The entire series of Papers was revised in early 2012 to take account of legislative changes and other developments. These Papers are addressed to, and written primarily for the benefit of Council Members and staff, but they are also available as a resource for the general public and students of Local Government.

## 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 must have their financial statements audited annually by a properly qualified auditor in accordance with [Australian Audit Standards](#).<sup>1</sup> The auditor's report is published annually to communities (via Councils' annual reports) and provided to the SA Parliament.<sup>2</sup>

However this is just one of a suite of audit mechanisms that apply to, or are available to Councils. Each Council also must have an audit committee<sup>3</sup> and a Council may, if it chooses, conduct an efficiency and economy audit of a selected part of its operations.<sup>4</sup> This paper is aimed at ensuring a clear understanding of the differences between these mechanisms.

## A range of control mechanisms

Councils apply a range of controls to their finances, and to 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 long-term financial plans, and infrastructure and asset 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 or 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 some 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.

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<sup>1</sup> See sections 128 and 129 of the [Local Government Act 1999](#) ("the Act").

<sup>2</sup> See section 131 of [the Act](#).

<sup>3</sup> See section 126 of [the Act](#).

<sup>4</sup> See section 130A of [the Act](#).

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.

Councils, as custodians of public assets and public finances, should aspire to the highest standards of financial governance and accountability. While significant financial management problems have not been experienced by South Australian Councils there has, nevertheless, been some public questioning of Councils' performance in financial areas.

The 2005 [Independent Inquiry into Local Government Financial Sustainability](#) was a substantive response to this questioning and it suggested a range of ways in which Councils can improve financial governance and financial reporting to ensure public confidence is maintained. In addition 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 statements is the most common "checking" requirement as the accuracy of published statements underpins substantial decisions by key stakeholders (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 [Local Government Act 1999](#) ("the 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 must have strategic management plans, which must include a long-term financial plan and an infrastructure and asset management plan.

[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 role of the CEO and staff 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.

Both the policy advice provided and the systems and processes put in place should focus on the Council achieving or maintaining long-term financial sustainability.

[The Act](#) provides for strategic management plans to be developed in consultation with communities. Councils' annual business plans also require consultation and must be

contrasted with longer-term plans. Annual performance measures must be set out in Annual Business Plans and reported upon in Councils' Annual Reports. In this way any Council observer – public, media or other governments, for example – can assess the performance of a Council against its objectives for a financial year.

Internal and external review and audit approaches sit within this framework and are part of a coherent whole.

Audit mechanisms do not take the place of the criminal law. Crimes such as theft or corruption are dealt with in Local Government in the same way as they are dealt with in other spheres of 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. An external auditor does not have the primary responsibility for prevention or detection of fraud. That primary responsibility rests with the CEO and elected Council Members. However, all audit mechanisms can assist in exposing areas where such activity might be occurring.

Both Council Members and senior staff are subject to legislation covering conflicts of interest<sup>5</sup> and the need to update registers of interests.<sup>6</sup>

Councils are also subject to duties to provide access to information<sup>7</sup>, to keep records,<sup>8</sup> and to facilitate external review of Council decisions.<sup>9</sup>

## Internal Controls

Audit systems rely on good primary accounting systems and internal controls. 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.

The [Local Government Financial Management Group](#) ("FMG") with funding from the [Local Government Research and Development Scheme](#), has published an ["Internal Financial Controls – Best Practice Manual"](#). This document provides both an excellent framework for a contemporary approach to internal controls in Local Government and a range of practical tools to assist in its implementation. More recently, the FMG has worked with a private company to develop a web-based system to allow any Council, if it chooses, to implement better practice internal financial controls and, most importantly, a system which facilitates monitoring and reporting of those controls.

[The 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 Act](#) makes specific provision for Councils to engage an independent auditor to undertake external annual auditing of both the Council's:

- financial statements; and

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<sup>5</sup> [Local Government Act 1999](#) sections 73 and 74 (elected members) and section 120 (the CEO)

<sup>6</sup> [Local Government Act 1999](#) sections 64 to 72 (elected members) and sections 111 to 119 (the CEO and senior managers)

<sup>7</sup> See the [Freedom of Information Act 1991](#)

<sup>8</sup> See the [State Records Act 1997](#)

<sup>9</sup> See the [Ombudsman Act 1972](#), and sections 74(5a), 93A, 94, 187A and 187B of the [Local Government Act 1999](#).

- internal financial controls.<sup>10</sup>

Having done so, the auditor is then required to provide a Council with two separate opinions:

- on the financial statements; and
- on the adequacy of its internal financial controls.<sup>11</sup>

The 2005 [Independent Inquiry into Local Government Financial Sustainability](#) 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 highlighted a number of limitations for Councils as a result. The LGA has employed several strategies to move towards greater consistency in Local Government approaches to auditing.

These strategies have included:

- Issuing Financial Sustainability Information Paper No. 4: *External Audit Specification*<sup>12</sup> which provides a model specification for Councils;
- Encouraging the successful establishment of the [SA Local Government Auditors Group](#) ('SALGAG') which promotes consistency in the audit and financial reporting functions of Councils; and
- Developing the Model Financial Statements which have materially improved the reliability, consistency, and comparability of financial reporting.

## Audit Committees

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 principal functions and extent of authority for operation of audit committees as specified in [the Act](#),<sup>13</sup> 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 plans<sup>14</sup> or annual business plans;
- proposing and reviewing the exercise of powers in relation to "other investigations" as specified under section 130A of [the Act](#) (e.g. the conduct of efficiency and economy audits<sup>15</sup>);

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<sup>10</sup> For more detail, see Local Government Financial Sustainability Information Papers:

- No 4 – *Scope of External Audit*; and
- No, 21 – *Internal Financial Controls*

at <http://www.lga.sa.gov.au/goto/fsp>

<sup>11</sup> Transitional provisions in the [Local Government \(Accountability Framework\) Amendment Act 2009](#) provide a period of grace before auditors have to comply with the requirements to audit, and to provide an opinion on, internal financial controls. For most Councils, the requirement to have an auditor provide an opinion on internal financial controls is not mandatory until the audit of the 2015-16 financial year. For 17 "prescribed" (i.e. metropolitan) Councils, the period of grace expires three years earlier, so that an auditor's opinion on internal financial controls must be provided no later than the audit of the 2012-13 financial year, unless the Council seeks and obtains a Ministerial exemption for a 12-month extension of time. Further information on internal financial controls is contained in LGA Financial Sustainability Information Paper 21 – '*Internal Financial Controls*' at <http://www.lga.sa.gov.au/goto/fsp>.

<sup>12</sup> Available at <http://www.lga.sa.gov.au/goto/fsp>

<sup>13</sup> [Local Government Act 1999](#) Section 41, and Section 126

<sup>14</sup> This would include a Council's long-term financial plan, and infrastructure and asset management plan, which s122 (1a) provides are both part of a Council's suite of strategic management plans.

- 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 external auditor; 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.<sup>16</sup>

### **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 Act](#)).

Section 130A of [the Act](#) 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.<sup>17</sup>

### **What are the issues for Councils?**

Understanding the various types of audits required or available to Councils under [the 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.

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<sup>15</sup> See Financial Sustainability Information Paper No. 5 – *Efficiency and Economy Audits* at: <http://www.lga.sa.gov.au/goto/fsp>

<sup>16</sup> For more information on the role of Audit Committees see Financial Sustainability Information Paper No. 3: *Audit Committees* at: <http://www.lga.sa.gov.au/goto/fsp>

<sup>17</sup> See Financial Sustainability Information Paper No. 5 – *Efficiency and Economy Audits* at: <http://www.lga.sa.gov.au/goto/fsp>

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 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.

### **Acknowledgement**

This project has been assisted by the [Local Government Research and Development Scheme](#).