Joint Treasury/Office of the Controller and Auditor-General Report to FEC: Public Audit Bill: Issues for Consideration by FEC

Introduction

This report provides joint advice from the Treasury and the Office of the Controller and Auditor-General (OAG) to aid the Finance and Expenditure Committee in its consideration of the Public Audit Bill. The report contains argument and recommendations on three issues that the Committee were requested to consider;

- Whether statutory provision for a Deputy Auditor-General to be appointed by the House is necessary and appropriate.
- Whether it is desirable for SOEs to be subject to effectiveness and efficiency audit by the Auditor-General.
- The prospect of greater co-ordination between the Auditor-General and the Parliamentary Commissioner for the Environment in the use of their resources.

The paper also provides information and recommendations on issues raised during the hearing of submissions on the Bill.

- Treatment of the Reserve Bank
- Replacement of surcharge powers and amendment to the Local Government Act.
- Triple Bottom Line Reporting
- Auditing Standards
- Criteria for adding new entities to the Auditor-General's mandate
- Inclusion of the NZ Local Government Association in the Auditor-General's mandate.

Separate papers discuss and provide recommendations on:

- The appropriateness of the Auditor-General's powers to inquire into the adequacy of services provided by Non-Government organisations (NGOs) and,
- The treatment of energy trusts and other trusts.
- The appropriateness of the House's power to direct on the Auditor-General's work programme priorities.

1. Appointment of the Deputy Auditor-General by the House

The Public Finance Act 1977 provides for statutory appointment of the Deputy Auditor-General and the Bill is drafted for this arrangement to continue. The Committee has been requested to consider whether it is necessary and appropriate for the Deputy Auditor-General to be appointed by the House of Representatives. The point of contention is not over whether there should be a Deputy, but rather who should appoint the Deputy (i.e. the Auditor-General or the authority that appoints the Auditor-General).

Parliamentary Counsel Office has advised that statutory appointment of the Deputy Auditor-General is not strictly necessary to expressly provide for periods where the Auditor-General is absent from Office. As a corporation sole the Auditor-General has perpetual succession.

The Auditor-General is of a view that although it may not be strictly necessary to provide for statutory appointment of the Deputy, such an arrangement is appropriate given the constitutional significance of the position and the likelihood that a Deputy will act as the Auditor-General during periods where an Auditor-General is absent from Office. A more detailed paper on the issues is available should the Committee wish to see it.

The Law Society supported statutory provision for a Deputy but did not signal a preference for the method of appointment.

Recommendation

The provision for statutory appointment of the Deputy Auditor-General be retained in the Bill**.**

2. Performance Audit of SOEs

The Minister in charge of the Audit Department indicated in his first reading speech that he would like the Committee to examine if the exclusion of SOEs from the application of clause 16(1)(a) (effectiveness and efficiency audits) is necessary.

In the Treasury's view, the primary argument for exposure of SOEs to effectiveness and efficiency audit is to reinforce performance pressure and supplement commercial disciplines on SOEs.

State Owned Enterprises (SOEs) are included within the mandate of the Auditor-General. The Bill provides that the Auditor-General must carry out audits of financial statements (clause 15), and may at any time examine any matters of compliance with statutory obligations, an act or omission to determine whether waste has resulted, an act or omission appearing to show a lack of probity or financial prudence, and any matter concerning an SOEs use of resources (clauses 16(1)(b)-(d)).

Other entities will be subject to audit of effectiveness and efficiency. However, the 1998 inquiry by FEC recommended that SOEs not be subject to this type of performance audit. The argument behind this recommendation has two strands.

First, it can be argued that Parliament does not need the public auditor to protect its own, or the general public's, purchase interest. It is important to the customers that purchase the services provided by an SOE that the services are provided in an effective and efficient manner. In the case of SOEs, this dimension of SOE performance can be judged through comparison with the SOE's competitors or to a more limited extent, through scrutiny of major users who closely monitor the service. In these cases, Parliament generally does not either directly purchase or otherwise fund SOEs to provide goods and services, either to it, or to other parties.

Second, Parliament does have an ownership interest in the performance of SOEs. It is crucial that Parliament is given appropriate information to monitor this interest. The relative absence of capital market constraints on SOEs reinforces this need. The financial attest audits and other performance auditing features provided in the Bill are designed specifically to protect this interest. These features when combined with the existing monitoring frameworks and governance mechanisms offer Parliament a substantial level of information that can be used to protect its ownership interest in SOEs.

The benefits of any enhanced commercial discipline provided by effectiveness and efficiency assessments (that cannot be captured by existing arrangements) needs to be balanced against the risk that such assessments will unduly constrain the successful operation of these businesses. SOEs primarily operate in competitive markets and exposure to effectiveness and efficiency audits may place constraints on SOEs that are not placed on comparable businesses, thus inhibiting the ability of an SOE to fulfil its primary obligation of operating as a successful business.

Treasury Recommendation

SOEs remain exempt from effectiveness and efficiency audits provided for in clause 16(1)

OAG view

The OAG does not share the Treasury view on the distinction between ownership and purchase interests. The OAG's view is that, in principle, the Auditor-General should have the same mandate in respect of all public entities. Whether an exception ought to be made in respect of SOEs is a matter that Parliament needs to decide.

3. Co-ordination between the Auditor-General and the Parliamentary Commissioner for the Environment

The Minister in charge of the Audit Department raised in his first reading speech the prospect of greater co-ordination in future between the Auditor-General and the Parliamentary Commissioner for the Environment in the use of their resources.

The two offices currently work closely in a number of areas, including performance audits concerning local government and environmental issues. It is not envisaged that the

autonomy or independence of either office would be affected were they to share resources more closely, or cooperate more generally in their work.

Recommendation

No legislative change would be necessary to achieve greater co-ordination between the Auditor-General and the Parliamentary Commissioner for the Environment.

4. Treatment of the Reserve Bank

Effectiveness and Efficiency Assessments

The Reserve Bank of New Zealand (RBNZ) is listed in Schedule 2 of the Bill making the Auditor-General responsible for appointing the Bank's financial auditor and initiating effectiveness and efficiency audits of the Bank's performance in implementing government policy.

The RBNZ have expressed concern that the Auditor-General's power to initiate performance audits could impinge on the perceived independence of the Bank[1]. These concerns can be largely alleviated if the existing mechanism in the Reserve Bank Act of New Zealand 1989 for initiating performance audits is retained.

Treasury Recommendations

The RBNZ be exempt from effectiveness and efficiency audits initiated under clause 16(1)(a) of the Bill.

The existing performance audit mechanism in section 167 of the Reserve Bank Act of New Zealand 1989 be retained.

The Auditor-General has indicated that he would accept this position, provided the RBNZ is subject to the financial audit mandate.

Financial Audits

Inclusion of the RBNZ in the Auditor-General's financial auditing mandate does not give rise to concerns about the perceived independence of the Bank and reflects Parliament's interest in holding the Executive to account for the use of public money. Bringing the RBNZ within the financial auditing mandate also rectifies the current anomaly where the RBNZ is the only significant part of the Crown reporting entity that is not subject to audit by the Auditor-General. This will give the Auditor-General greater confidence in attesting to the consolidated Crown Financial Statements.

Recommendation

Continue to list the RBNZ in Schedule 2 of the Bill making the Auditor-General responsible for appointing the Bank's financial auditor and conducting investigations under clauses 16(b)-(d).

[1] For a detailed statement of this argument refer to the Bank's submission and the Minister of Finance's letter to the Committee of 18th September.

Effectiveness and Efficiency 'Templates'

The Committee has requested that Treasury and the OAG comment on how the approach taken for assessing effectiveness and efficiency of SOEs might be applied to the RBNZ if clause 16(3) remains unchanged. Clause 16(3) exempts SOEs from effectiveness and efficiency audits. As noted above, SOEs are generally subject to competition, or close monitoring by large third party clients, with respect to services being purchased from them. The RBNZ's services are, however, purchased by the Crown. Therefore, in contrast to SOEs it is appropriate that some provision for effectiveness and efficiency audits of the RBNZ be made in section 167 of the Reserve Bank of New Zealand Act.

The Auditor-General does not have a generic "template" for effectiveness and efficiency audits. Subject matter and scope of a performance audit are determined during the strategic audit plan (SAP) process. The OAG then tailors a range of performance expectations appropriate to the subject matter and the nature of the entity being audited. In doing so, the Office draws on international best practice, and commonly seeks expert input.

The ensuing audit is based on these expectations, and is conducted in accordance with in-house practices and policies. Expert assistance is used where necessary.

If provision for the initiation of effectiveness and efficiency assessments is retained in section 167 of the Reserve Bank of New Zealand Act then it would be the responsibility of the Treasurer to select an assessment methodology that suited the form of assessment required. It is likely that the process used in developing the methodology would be similar to that used by the Auditor-General in the selection and scoping of performance audits generally (as set out above). Indeed the Treasurer may wish to appoint the Auditor-General to undertake the assessment – possibly with the help of external advisers.

The Committee should note that a report on a performance audit under section 167 stands referred to the House.

Treatment of the Overseas Investment Commission

The Committee has also requested Treasury and the OAG to provide information on how the proposed treatment of the RBNZ would affect the status of the Overseas Investment Commission (OIC). The OIC was established under the Overseas Investment Act 1973 and it administers the Government's foreign investment policies. The RBNZ currently provides for the Commission Secretariat and pays for costs not met by application fees. It does so under an agreement entered into under section 13 of the Overseas Investment Act.

The OIC is not a body corporate, and does not currently exist as a financial reporting entity in its own right (i.e. it has no statutory duty to produce audited financial statements

on its own). Its finances are audited as part of the financial audit of the RBNZ. The OIC is required to report regularly to Parliament on its activities.

Because the OIC is serviced by the RBNZ, exemption of the RBNZ from clause 16(1)(a) would also apply to the OIC. However, effectiveness and efficiency assessments of the OIC do not raise the same risks for monetary policy as those for the RBNZ. Thus it is desirable for the Auditor-General to have this mandate for the OIC.

The effect of listing the OIC in Schedule 2 would be:

- were it in future to produce its own financial statements and be required to have them audited, the Auditor-General would be the auditor of those statements in accordance with clause 15 of the Bill; and
- the Auditor-General would at any time be able to conduct a performance audit of, or inquiry concerning, the OIC.

Treasury Recommendation

The Overseas Investment Commission be listed as a public entity in Schedule 2 of the Bill.

OAG View

The OAG is not in a position to express a view on whether the OIC should currently be subject to effectiveness and efficiency audits. However, it agrees that, if the OIC is likely to be required to produce its own financial statements, it should be a public entity and be subject to the full mandate under Part 3 of the Bill.

5. Replacement Of Power To Surcharge With Provision For Legal Action To Recover Losses

The Bill replaces the existing powers in the Public Finance Act 1977 where the Auditor-General can surcharge members of public bodies for losses incurred by unlawful actions with a mechanism for local authorities (in the first instance) or the Crown (in the second instance) to initiate legal action to recover losses. The new requirements are to be incorporated in the Local Government Act.

The objective of the new provisions is to encourage local authorities to recover losses. The Department of Internal Affairs has been consulted about the provisions and agrees with them in principle.

Two issues have arisen in relation to the proposed provisions.

The first issue relates to the nature of the new mechanism to recover losses. The Law Society notes that the new provision imposes significant personal liability on members of local authorities and that the burden of this liability is more onerous than that on Ministers of the Crown. This differential treatment prompted the Law Society to suggest that the

new mechanism to recover losses should be withdrawn for reconsideration. In recommending that the mechanism contained in the Bill remain unchanged we note that:

- submissions from Local Government NZ and Christchurch City Council did not oppose the new mechanism
- Local Government members' liability has historically been different from that of Ministers and other statutory Office holders.
- The current review of the Local Government Act provides an opportunity for the nature of the liability to be reassessed in the future.

The second set of issues arises from the specification of how the new mechanism would actually work in practice. The submission from the Christchurch City Council recommends that the Bill reflect that in practice the Crown will be called on to initiate proceedings to recover losses on behalf of local authorities. We support this approach and recommend that the Minister of Local Government is made responsible for recovering losses on behalf of the Crown. Drafting improvements will be made to the Bill to reflect this responsibility. In addition we agree with the recommendation of the Department of Internal Affairs that Ministerial action to recover losses be subject to objective criteria.

Advice from Crown Law suggests that it would be appropriate to provide that the Minister of Local Government's decision should be dependent upon the OAG having reported and expressed a view that a loss has occurred.

Recommendation

The Bill be amended to reflect the likelihood that the Crown will be called on to initiate proceedings to recover losses on behalf of local authorities, and to insert criteria for a decision by the Minister of Local Government to take recovery action.

6. Triple Bottom Line Reporting

The NZ Businesses for Social Responsibility promoted the proposition that public entities should report on not only financial performance but also social and environmental measures.

In general, with the significant exception of some SOEs and some other companies, the Crown does not own organisations because of the financial return it can make on them. Instead it owns them to contribute to the achievement of its policy goals, or policy goals established by Parliament. Reporting by Government agencies should, accordingly, have a wider focus than only financial matters.

The legislation relating to reporting does not limit departments and other agencies to reporting only financial information, and in fact usually requires reporting on other matters (notably the nature of outputs that have been produced). Having said that, however, there are two points to note:

- There is not necessarily a simple one to one correspondence between a government agency and an outcome that the Government wishes to achieve. More than one government agency may contribute to the achievement of a desired outcome. The Government intervenes in ways other than direct service delivery by its agencies (e.g. regulation). Causality can be hard to establish. These considerations suggest that it may not be sufficient to simply focus on a single agency when trying to assess the effectiveness of Government interventions;

- The public management system does need to consistently generate better information on the effectiveness of government interventions, whether that relates to social, environmental or other impacts. In its response to the *Report of the Finance and Expenditure Committee on the Briefing from the Controller and Auditor-General on the 3rd Report for 1999 and the 1st Report for 2000*, for example, the Government "notes that impact evaluation is used infrequently and wishes to rectify this situation."

The Public Audit Bill does not seem to be the most appropriate vehicle for addressing these concerns. It is not a vehicle for reporting requirements. Currently the most important Act in terms of reporting by Government organisations is the Public Finance Act 1989, which contains requirements for both ex ante and ex post reporting by departments and Crown entities, as well as consolidated reporting by the Crown. The requirements of the Public Finance Act 1989 go wider than narrow financial reporting and include reporting on outputs, and some limited ex ante reporting on outcomes. Other legislation that covers reporting includes the State Sector Act 1988, the State-owned Enterprises Act 1986 (reporting by SOEs), and the Fiscal Responsibility Act 1993 (high level fiscal and economic reporting). Legislation establishing a particular agency may also include reporting requirements. In respect of local government, additional reporting requirements are a matter for the Local Government Act 1974.

Recommendation

No change to the Bill is necessary to facilitate adoption of the principles of triple bottom line reporting.

7. Auditing Standards

The Institute of Chartered Accountants (ICANZ) submitted that clause 23 of the Bill should be amended so the Auditor-General has a statutory duty to comply with auditing standards developed by the Institute. ICANZ considers that Parliament will receive the best possible assurance of the accuracy of the accountability information it receives from the Executive if audit standards are developed and published independently of the Auditor-General. The Institute also argued that granting parallel powers to the Auditor-General is unnecessary and inefficient and that the Auditor-General can provide for any additional requirement for his own purposes through a practice manual.

The Auditor-General opposes mandatory compliance with auditing standards developed by an external private body primarily because the Office cannot be certain of the future direction of the Institute's auditing standards. The position in respect of auditing

standards is different from that in respect of financial reporting standards, which are approved by an independent statutory body (the Accounting Standards Review Board). Allied to this uncertainty is the concern that mandatory compliance with standards that the Auditor-General does not control will cut across the notion that the Auditor-General is accountable for all aspects of public audit. The Auditor-General also notes that there are areas of public audit where the Institute's standards are silent. Thus by necessity the Auditor-General has had to develop standards in these areas. Finally, it can be noted that the Bill is framed in such a way that the Auditor-General is accountable for the standards used in audits and that the standards applied are transparent (e.g. the Auditor-General must publish and report the general auditing standards that the Auditor-General applies at least once every three years).

Treasury agrees with the Auditor-General's views. Although practice manuals meet most of the Auditor-General's needs for interpreting and supplementing the Institute's standards, there is a risk that the Institute's standards may take a direction that is not easily applied in the Auditor-General's work. The Auditor-General currently bases his standards on the Institute's standards, and sets out any areas where they may differ.

Recommendation

Do not change the provision for the Auditor-General to establish auditing standards.

8. Criteria For Adding New Entities To The Auditor-General's Mandate

Submissions from both ICANZ and the Law Society recommended that there be listed in the Bill an explicit set of criteria for determining if an entity should be added to Schedule 2 in the future.

Clause 19 of the Bill contains a set of criteria for 'audit by arrangement'. These criteria are based on the principles set out in the FEC's 1998 report on its inquiry into Audit Office legislation. They provide a useful guide for deciding if an entity should be included as a public entity in Schedule 2 of the Bill. The criteria contained in clause 19 are:

- The entity exists for a public purpose; and
- The entity is, or ought reasonably to be, accountable to any or all of the Crown, the House of Representatives, the public, or a section to the public for the exercise of its functions and the management of its resources; and
- No practical means exist for those to whom the entity is, or ought reasonably to be, accountable to appoint an auditor of the entity[2]; and
- It is practicable and in the public interest that the Auditor-General accepts the appointment.

The recommendation as to whether an entity ought to be made a "public entity" by Order in Council should be a matter for the Minister of Finance, having regard to these criteria.

[2] We also suggest a drafting improvement to clause 19 that would omit the words "no practical means exist" and replace them with "it is not practicable".

Recommendation

Provide in clause 44 that an Order in Council be made on the recommendation of the Minister of Finance, having regard to the criteria set out in clause 19(2).

9. Inclusion of NZ Local Government Association

The NZ Local Government Association sought to be excluded from the Auditor-General's mandate, on the ground that inclusion may affect perceptions of the independence of national representative bodies. As the Bill is drafted, the Association falls under the control test (i.e. it is controlled by other public entities).

There is no reason in principle why national representative bodies ought to be excluded from the Auditor-General's mandate, so long as they are controlled by the public entities they represent.

Recommendation

No change be made to the Bill.

Summary of Recommendations

Treasury and OAG advise that the Committee recommend:

1 The provision for statutory appointment of the Deputy Auditor-General be retained in the Bill.

2 SOEs remain exempt from effectiveness and efficiency audits provided for in clause 16(1) [and note that the OAG has a different view here].

3 No legislative change would be necessary to achieve greater co-ordination between the Auditor-General and the Parliamentary Commissioner for the Environment.

4 i The RBNZ be exempt from effectiveness and efficiency audits initiated under clause 16(1)(a) of the Bill.
   i. The existing performance audit mechanism in section 167 of the Reserve Bank Act of New Zealand 1989 be retained.
   ii. Continue to list the Reserve Bank of New Zealand in Schedule 2 of the Bill making the Auditor-General responsible for appointing the Bank's financial auditor and conducting investigations under clauses 16(b)-(d).
   iii. The Overseas Investment Commission be listed as a public entity in Schedule 2 of the Bill.

5 The Bill be amended to reflect the likelihood that the Crown will be called on to initiate proceedings to recover losses on behalf of local authorities, and to insert criteria for the Minister of Local Government to consider when deciding whether to initiate recovery action.

6 No change to the Bill is necessary to facilitate adoption of the principles of triple bottom line reporting.

7 Do not change the provision for the Auditor-General to establish auditing standards.

8 Provide in clause 44 that an Order in Council be made on the recommendation of the Minister of Finance, having regard to the criteria set out in clause 19(2).

9 The Local Government Association of NZ not be removed from the Auditor-General's mandate.