

LEGISLATIVE COMPLIANCE IN THE PUBLIC SECTOR

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INTRODUCTORY COMMENTS

The law places a vast array of requirements on organisations in both the private and public sectors. Furthermore there is no indication that the quantum or complexity of these requirements is about to diminish.

Compliance with the law is a matter to be taken seriously. The consequences often go far beyond the obvious downsides of breaking the law – fines and penalties – to more intangible side effects such as unwelcome publicity, wasted time and the attendant impacts on staff morale.

Conversely, significant benefits can accrue to those organisations who "manage" their compliance responsibilities and can demonstrate they are good corporate citizens. Ensuring compliance, however, doesn't come without a cost. Organisations need to plan and manage their compliance obligations – and this process must be able to withstand external scrutiny.

In this paper I will discuss legislative compliance primarily from the point of view of the Audit Office – Parliament's appointed auditor of the public sector. I believe that my comments will have relevance to the private sector and also to those within or assisting organisations to meet the challenges of change.

The areas I will cover are:

Observations from the perspective of the public sector external auditor.

Implications for the governing body and management of organisations.

Implications for internal auditors.

OBSERVATIONS FROM THE PERSPECTIVE OF THE PUBLIC SECTOR EXTERNAL AUDITOR

Audit Office Responsibilities

There is an expectation that, when the Audit Office attests to the fair presentation of the financial statements of a public sector organisation in the audit report, the organisation has also complied with applicable laws and regulations. This expectation is unreasonable given the scope and limitations of an audit.

The Audit Office does, however, accept responsibility for checking that the transactions and activities of public sector organisations are lawful. This responsibility reflects the fact that public sector organisations are creatures of statute and that their purposes and powers and functions are typically constrained by legislation. Where we observe instances of non-compliance, and where non-compliance meets a test of 'significance', we ensure the non-compliance is publicly reported.

Professional Auditing Standards

In New Zealand there is no professional auditing standard on the audit of legislative compliance. The "authoritative" standards in this area are International Auditing Standard 250: *Consideration of Laws and Regulations in an Audit of Financial Statements* (ISA-250) and Australian Auditing Standard 210: *Irregularities, Including Fraud, Other Illegal Acts and Errors* (AUS-210).

The Institute of Chartered Accountants of New Zealand (ICANZ) has produced an exposure draft – Auditing Standard 212: *Consideration of Laws and Regulations in an Audit* (ED/AS-212) – which is expected to be issued as a final standard later this year. ED/AS-212 will apply to the audits of organisations in both the public and private sectors.

When ED/AS-212 becomes a standard it will, in my opinion, have a significant impact on the audits of private sector organisations. The assumption in ED/AS-212 is that the organisation subject to audit will:

have an understanding of the legal and regulatory framework applicable to that organisation; and

be able to demonstrate how it is complying with that framework.

As part of the external audit process auditors will be seeking evidence, supported by representations from the governing body of the organisation, of compliance with legislation and regulations.

Audit Office Auditing Standards

The Audit Office has prepared its own auditing standards (the OAG Auditing Standards) for application to the audit of public sector organisations. The OAG Auditing Standards are entirely consistent with the ICANZ auditing standards but enhance and expand on these to reflect the public sector perspective.

The OAG Auditing Standard that deals with the issue of legislative compliance is OAG-16: *The Audit of Compliance with Legislative Requirements*. OAG-16 was issued in June 1995 and has been applied to the audits of public sector organisations from, and including, 30 June 1996 balance dates. The requirements of OAG-16 are similar to ED/AS-212. OAG-16 will be harmonised with ED/AS-212 when ICANZ issue this as a standard.

What The Audit Office Has Observed

OAG-16 has been in effect for over two reporting periods now and, it is fair to say, auditors have experienced difficulty in applying the standard. Two significant issues have arisen – both of which are discussed below. The first issue relates to the absence of a systematic approach by public sector organisations to minimise the risk of non-compliance with legislative requirements. The second issue relates to a misunderstanding about the assurance provided by the external audit in relation to legislative compliance - the "expectation gap".

The Response of Public Sector Organisations to Legislative Compliance

A key assumption within the current auditing standards (including OAG-16) is that organisations understand their responsibilities with regard to legislative compliance and have taken steps to ensure the risk of non-compliance is minimised. Despite the logic of OAG-16 and ED/AS-212 in this regard our observation is that, in general, organisations in the public sector have not addressed the matter of legislative compliance in a coherent or comprehensive manner.

Few public sector organisations have developed comprehensive systems. While there is undoubted awareness, this has not translated into systems that enable monitoring and assurance. Universally it is either:

assumed a functional manager is aware of the need to meet legislative requirements; or

in a step to developing compliance systems, the requirement to comply has been built into employment contracts/performance agreements.

The latter requirement provides some feedback to executive management but is not directly related to a comprehensive compliance programme.

While our observations regarding the absence of developed systems have not been reported in our audit opinions, public sector organisations have received substantial management report/letter comment focused on recommending the development of comprehensive systems.

Many public sector organisations have been addressing the issue of risk management. Often "drivers" such as insurance needs have been influencing such reviews. Management of legislative compliance has been seen by many as an exercise in risk management and is now starting to be integrated into the broader issue of risk management. From this approach we have noted:

risk management brings a cost/benefit approach to managing legislative compliance;

generally risk management leads to internal monitoring and reporting; and

defensive mechanisms are developed when actual adverse results occur.

At the moment this reflects how many public sector organisations are starting to respond. The actual result is largely yet to be seen.

The Expectation Gap

Our observations suggest that the governing body and management of some public sector organisations are taking unwarranted comfort from the external audit – to the extent that an unqualified audit report is evidence of a clean bill of health in respect of legislative compliance. This unfounded belief may also be held by key stakeholders external to the organisation subject to audit.

The existence of an expectation gap is of concern. This concern is compounded if organisations use the audit report as evidence that they are meeting their legislative compliance responsibilities.

How the Audit Office is Going to Respond to these Concerns

Improving the Awareness of Legislative Compliance within Public Sector Organisations

It is apparent that the Audit Office needs to re-orient the audit to encourage public sector organisations to put in place systems and procedures (appropriate to their nature and size) that provide assurance that they are complying with legislative requirements. This is a major area of focus in order for the Audit Office to provide the appropriate level of assurance to Parliament that organisations in the public sector are meeting their legislative responsibilities.

On a sector basis we intend to 'stocktake' the state of legislative compliance within organisations against a predetermined benchmark and report the findings to Parliament. This aspect of our strategy is to be initiated in selected sectors as part of the 1998/99 audit round.

We intend raising the awareness of the importance of legislative compliance at the individual organisation level through management reporting. This will involve advocating the notion of 'compliance programmes'.

We will conduct follow up enquiries on a sector basis to gauge the extent of improvement in awareness of legislative compliance and report to Parliament. This step will be initiated some two to three years after the initial benchmarking exercise.

Reducing the Expectation Gap

We will report the Audit Office approach to legislative compliance to Parliament and to public sector organisations. This will put our approach to legislative compliance on public record. The approach is likely to be restated at the individual organisation level by means of the audit engagement letter and in the report to management.

IMPLICATIONS FOR THE GOVERNING BODY AND MANAGEMENT OF ORGANISATIONS

There are sound business reasons why organisations should approach their obligations to comply with the law in a systematic way – not simply because it would make life easier for the external auditor. These reasons are sourced back not only to the need to eliminate or minimise the risk of non-compliance (and the associated harmful consequences) but also as a demonstration of corporate responsibility.

It is not the purpose of this paper to tell organisations what systems and procedures they must have in place – suffice to say that good intentions are not enough. It is the responsibility of each organisation to determine the compliance programme that is appropriate to its size and nature. Any compliance programme, however, will have a number of common features:

It goes without saying that an effective compliance programme must start with commitment at the top. The governing body is ultimately responsible for legislative compliance and it follows that its members demonstrate they are committed to authorise and endorse the compliance programme within the organisation.

A compliance programme should form part of an organisation's risk management processes. It does not need to be an expensive white elephant. Conversely a compliance programme should be more than a paper scheme – it needs to be implemented and it needs to be monitored.

Laws and regulations change over time. A compliance programme needs to be responsive to changes in the legislative environment.

There is a limited amount of guidance available on compliance programmes. The Audit Office has made use of material provided as a result of the Institute of Chartered Accountants of New Zealand (ICANZ) course presented by Richard Osbourne and Bruce Houghton in April/May 1997 entitled 'Legal Compliance Programmes – Saving Businesses and Directors from Legislation and the Cost of Failure.'⁽¹⁾

IMPLICATIONS FOR INTERNAL AUDITORS

The internal auditor plays a key role as the corporate watchdog of an organisation – particularly in identifying risks and assessing the adequacy of the organisation's systems and procedures to respond to those risks. The need for the governing body and management to be assured that the organisation is meeting its legislative obligations is one of the more important risks to be considered. The internal auditor has a critical role to play by providing independent advice to the governing body and management as to whether they can "sleep at night" when it comes to legislative compliance.

CONCLUSION

Legislative compliance is a fact of life in doing business in New Zealand. Forthcoming changes in auditing standards will throw the spotlight on the adequacy of systems and procedures within organisations and whether they provide assurance the organisation is complying with the law. Those organisations that have put in place effective compliance programmes will be able to respond to the future challenges posed by the increasing quantum and complexity of laws. Organisations operating on a "she'll be right" basis may not be so lucky.

Notes :

(1) A reference copy of the course paper is held by ICANZ in wellington (Professional Development Course Paper NO. 523). Alternatively an updated version of this paper can be obtained from Bruce Houghton of Hesketh Henry, Barristers and Solicitors, Private Bag 92093, Auckland Phone (09) 375 8700.