

**Report on the Efficiency and Effectiveness of  
the Office of the Controller and Auditor-  
General of New Zealand by an International  
Peer Review Team.**



*March 2008*



# Table of Contents

	Page
<b>1. Introduction .....</b>	<b>4</b>
<b>2. Conduct of the Review.....</b>	<b>4</b>
<b>3. Overview .....</b>	<b>5</b>
<b>4. Governance and Management .....</b>	<b>9</b>
4.1 Introduction.....	9
4.2 Organisation Structure.....	10
4.3 Governance Framework .....	11
4.4 Management .....	13
4.5 Performance Management.....	19
4.6 Culture and Values.....	20
4.7 External Stakeholder Relationships .....	21
4.8 External Performance Assessment.....	24
<b>5. Financial Statements and Assurance Auditing .....</b>	<b>24</b>
5.1 Introduction.....	24
5.2 Financial Statements Audit.....	25
5.3 Business Model.....	26
5.4 Audit Appointment/Allocation .....	30
5.5 Audit Fee Setting and Monitoring .....	34
5.6 Annual Audit Performance.....	36
5.7 Schools Audits .....	36
5.8 Audit New Zealand .....	38
5.9 Long Term Council Community Plans (LTCCPs) .....	45
5.10 The Controller Function .....	47
<b>6. Performance Auditing, Good Practice Guides and Inquiries .....</b>	<b>50</b>
6.1 Introduction.....	50
6.2 Performance Auditing .....	50
6.3 Good Practice Guides.....	65
6.4 Performance Reporting.....	66
6.5 Inquiries.....	66
<b>7. Suggestions for Improvement .....</b>	<b>70</b>
7.1 Governance and Management .....	70
7.2 Financial Statements and Assurance Auditing .....	71
7.3 Performance Auditing, Good Practice Guides and Inquiries .....	73
<b>8. Note of Appreciation .....</b>	<b>76</b>
<b>Attachments:</b>	
1. <u>Terms of Reference .....</u>	<u>77</u>
2. <u>Review Team Members.....</u>	<u>78</u>
3. <u>Interviews conducted.....</u>	<u>79</u>
4. <u>Background Review Documents.....</u>	<u>83</u>
5. <u>Background on the New Zealand Public Sector.....</u>	<u>84</u>
6. <u>Documents Examined.....</u>	<u>89</u>

## Abbreviations – A-Z

A.	AA-G	Assistant Auditor-General
	ACAG	Australasian Council of Auditors-General
	A-G	Auditor-General ( <i>although the full title is Controller and Auditor-General, the approach in this Report is to use the accepted abbreviation. This also applies to the use of the term Deputy Auditor-General</i> ).
	ANZ	Audit New Zealand
	ASD	Audit Status Database
	ASP	Audit Service Provider
C.	CAG	Controller and Auditor-General
D.	DCAG	Deputy Controller and Auditor-General
E.	EAP	Employee Assistance Programme
	EEO	Equal Employment Opportunity
F.	FRSB	Financial Reporting Standards Board
	FTE	Full Time Equivalent
H.	HR	Human Resources
I.	ICT	Information and Communications Technology
	IFRS	International Financial Reporting Standards
	INTOSAI	International Organization of Supreme Audit Institutions
	IS	Information Services
	IT	Information Technology
L.	LGNZ	Local Government New Zealand
	LTCCP	Long Term Council Community Plans
M.	MOU	Memorandum of Understanding
	MP	Member of Parliament
N.	NAMS	National Asset Management Steering Group, set up by Association of Local Government Engineers
	NZQA	New Zealand Qualifications Authority
O.	OAG	Office of the Auditor-General
	OFFICE	The Auditor-General's Office, including the Office of the Auditor-General and Audit New Zealand and, where necessary, Appointed Auditors
	OPC	Officers of Parliament Committee
P.	PAG	Performance Audit Group
	PPG	Professional Practices Group
	PWC	PricewaterhouseCoopers
Q.	QA	Quality Assurance
R.	R&D	Research and Development
S.	SOLGM	Society of Local Government Managers
	SPASAI	South Pacific Association of Supreme Audit Institutions

# Glossary of Terms

## **Allocation Model**

A process whereby Audit Service Providers are selected by the Auditor-General against an established set of criteria

## **AMP Plan**

A private sector superannuation plan managed by AMP Financial Services

## **Appointed Auditor**

An Appointed Auditor is the person appointed by the Auditor-General to sign the audit opinion of a public entity on his behalf. Appointed Auditors are normally either partners of chartered accounting firms or directors of Audit NZ, although there are exceptions for the audits of some smaller entities.

## **Climate Surveys**

Organisational surveys conducted by independent consultants to assess staff attitudes and attributes

## **Contestable Model**

A process whereby Audit Service Providers are generally selected on the basis of an open tender process

## **Controller Function**

The Controller functions are described in Section 5.10 of this report

## **Enhanced Financial Audits**

Enhanced financial audits are described in sub-section 5.3.5 of this report

## **Leadership Development Centre**

New Zealand's training centre for senior State sector managers and leaders

## **Leadership Teams**

- The OAG Leadership Team comprises the Auditor-General, Deputy Auditor-General and all Assistant Auditors-General
- The Audit New Zealand Executive Leadership Team comprises the Executive Director, his General Managers and the Assistant Auditor-General responsible for Corporate Services
- The combined Leadership Team comprises all members of the OAG and Audit New Zealand Leadership Teams

## **Professional Practices Group**

The team responsible for developing and enhancing Audit New Zealand's professional competence. It reports to the General Manager, Professional Practices

## **Quality Control Manual**

Audit New Zealand's document containing all policies and procedures of the organisation. It formally documents the organisational system of quality control. All employees carrying out audit or assurance must comply with the Manual.

## **Select Committees**

Multi-party Parliamentary Committees which conduct annual examinations of the budgets and performance of public entities within their subject area

## **Substantiator**

Member of the Performance Audit Group, independent of a particular performance audit, who carries out a review to ensure that there is evidence in the working papers to support the statements made in the draft report for that audit

## **TeamMate**

Audit New Zealand's computer software programme which provides electronic management of audits and permits audit working papers to be stored electronically rather than in a 'paper' format

## **“Team Space”**

Locations or folders provided on the Office's intranet for specific staff teams and groupings

# 1. Introduction

- 1.1. This Report was prepared by a Review Team in response to Terms of Reference provided by the CAG, Mr Kevin Brady (see Attachment 1). Drafts of the Terms of Reference were provided to Review Team Members before being finalised. Brief background information on each of the five Team Members is included in Attachment 2. The Coordinator of the Review Team, Pat Barrett, was fully consulted on membership of the Review Team. His suggestion to conduct the Review in accordance with the Australasian Council of Auditors-General Peer Reviews and Voluntary Development Quality Assurance Reviews – Core Reference Modules was accepted by Mr Brady. However, a number of areas specifically relevant to the New Zealand Office were added. It was also agreed that a Draft Report would be provided to the Controller and Auditor-General by 18 December 2007, with a response from Mr Brady by 28 February 2008 and a Final Report to be delivered by 31 March 2008. All commitments were met.

# 2. Conduct of the Review

- 2.1. Initial discussions concerning the conduct of the Review took place in Wellington on 23 and 24 November 2006 between the Review Coordinator and the Controller and Auditor-General and Deputy Controller and Auditor-General. These discussions also provided an opportunity for familiarisation with the OAG and Audit New Zealand, as did discussions with senior staff at the time (see Attachment 3). Further Review preparation included examination of Background Documents (see Attachment 4) and a range of other Documents provided by the Office which were added to progressively over the Review period (see Attachment 6). These Documents included the previous Peer Review of the New Zealand Audit Office in 2001 under the auspices of the Australasian Council of Auditors-General, and the most recent Peer Review by the Australian National Audit Office of two performance audits prepared by the Performance Audit Group within the OAG. As noted in Attachment 3, the Review Coordinator had discussions with the latter Peer Review Team in Wellington on 23 November 2006 and in Canberra on 13 December 2006.
- 2.2. The extensive nature and content of the foregoing discussions and documentation provided had two main benefits. They allowed for a considerable range of issues and views to be considered by the Review Team well before the on-site review conducted in September. As a result, the Team had the opportunity to be better prepared and focussed to make best use of their time in Wellington, including further interviews with nominated stakeholders and those requesting interviews with the Team. The pre-review activities were a factor in determining the dates for the on-site review. It was decided that a two week period from 17 to 28 September was appropriate. One Member of the Team located in Wellington was able to commence interviews in the week beginning 10 September, which proved to be of considerable assistance in completing an extensive range of interviews.
- 2.3. Following consideration of the Terms of Reference, it was decided that the Review would cover three segments of the operations of the Office as follows:
- Governance and Management (including all Corporate Services)
  - Financial Statement and Assurance Auditing (including the Controller Function and LTCCP audits); and
  - Performance Auditing, Good Practice Guides and Inquiries.

- 2.4. Review Team Members were selected on the basis of experience and professional background and qualifications in each of these three areas. Because of the extent of activity and resources involved in the second segment above, the Controller and Auditor-General agreed to have two Team Members cover that segment. Obviously, there were both overarching and common issues impacting on all three segments that needed to be coordinated to avoid unnecessary duplication of activity. While all Team Members were sufficiently experienced to manage this situation effectively, it was also apparent that the Review would benefit from their different perceptions of the issues. This was considered particularly relevant to ensuring a more cohesive organisation involving the respective roles of, and the relationships between, the OAG (as described at sub-section 4.2.1) and Audit New Zealand (as described at sub-section 5.8.1).

### 3. Overview

*“.....audit does not exist merely to check on what public organizations are doing, it must also act as a catalyst for change through constructive but critical challenge. Increasing insight and facilitating foresight is set to feature ever more prominently in this task.”*

Joseph McHugh, Deputy Editor, Public Finance, CIPFA, London, 2007<sup>1</sup>

- 3.1. The Auditor-General’s Office (the Office) is a relatively small but highly regarded organisation both in New Zealand and internationally. The Office operates in the context of a developed, highly performing and sophisticated national economy and an innovative public service that has been used as a model by many countries. On the one hand, limited resource availability and product scope might inhibit performance compared with that of other similar Offices but, on the other, the foregoing factors tend to raise expectations of the Office. The Review Team was conscious of such a tension but concluded, in relation to a number of performance criteria, that the Office would rate highly both absolutely and relatively in any international comparison.
- 3.2. A central requirement of any professional audit practice is to know and understand the environment in which audit activity is conducted. The Team not only had the opportunity to speak with an extensive range of stakeholders of the Office to test its own knowledge and understanding of the New Zealand Public Sector, it also had the advantage of tapping into the wide-ranging experience and knowledge of Neil Walter, throughout the Review, as a Team Member. Neil provided considerable background information for the Team, including a Paper on the New Zealand Public Sector as Attachment 5 to this Report. The Paper provided a useful context for the Review, particularly with its focus on performance and results.

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<sup>1</sup> Comment included in a Public Management and Policy Association Report entitled “Watchdogs Straining at the Leash”. Edited by Michaela Lavender, November 2007 (page 5)

- 3.3. The Review Team was impressed by the robust legislative framework applying to the public sector and to the Office. The *Public Audit Act 2001* was intended to strike an acceptable balance between:
- the independence of the Auditor-General, in particular the ability to act without direction or improper influence by the Executive or the Legislature;
  - the need for a sound working relationship between the Auditor-General, Parliament and the Executive; and
  - the need for the Auditor-General to be properly accountable to Parliament.
- 3.4. Importantly, establishing the Auditor-General as an Officer of Parliament was to ensure the Auditor-General's independence. The Office accepted that the Controller and Auditor-General, as an Officer of Parliament and a Corporation Sole has the same level of accountability as comparable entities in the public sector. It is recognised that the Auditor-General's role as an Officer of Parliament does create a tension between being accountable to Parliament while recognising that Parliament is best served by an Auditor-General free from any political interference. The same comment applies to the statutory position of Deputy Auditor-General. The effectiveness of the Office is enhanced by the seamless integration of governance at the top of the organisation, reflecting the complementary and cooperative relationship between the two current appointees.
- 3.5. While some concerns were expressed to the Review Team about the clarity of roles and relationships between the Auditor-General (and the Office) and Parliament, the legislative intent is quite clear. Differing perceptions about action taken, or not taken, are best addressed by direct and open communication. Independence is called into question when one is involved in processes or related decision-making and is also responsible for the review or audit of the activity. It was clear that the Auditor-General and the Office are very sensitive to issues of independence and accountability and the appropriate action, including independent review, to provide assurance to the various stakeholders, not least to Parliament itself.
- 3.6. Particular issues examined by the Review Team included the organisation and structure of the Office (covering the role and effectiveness of sector managers and any apparent duplication of activities); relationships with its various stakeholders; audit planning, selection, methodology and conduct (including contestable and "allocation" approaches to auditor selection and the coverage and conduct of "enhanced" financial statement audits); knowledge management, performance management and assessment; quality assurance; implementation of audit findings and recommendations; and the complex and rapidly-changing nature of the work of the Office.
- 3.7. The Office has undergone significant and wide-ranging change since the last Peer Review in 2001. Its workload has increased in both volume and complexity. Its legislative and operating environment has altered in a number of ways. Its budget and staffing establishment have expanded. And significant improvements have been made to its structures, systems and operations.
- 3.8. The relationships of the office with its key stakeholders are generally very positive. Its work is respected across government. Central agencies in particular see it as supportive of their efforts to improve public sector performance. It is highly regarded by local government. Parliamentary Select Committees depend heavily on advice from the OAG



and appointed auditors in their examination of departmental estimates and annual reports. Ministers find it helpful to receive annual financial audit reports on their portfolio agencies and spoke well of the work of the Office. Parliament also values the Office's work, although the recent inquiry into electoral advertising has obviously strained the Auditor-General's relations with political parties. Recent independent stakeholder surveys bear out the high levels of satisfaction encountered by our team.

- 3.9. Except as discussed in sub-section 5.3, the financial and assurance work of the Office is largely non-discretionary. The main areas of discretionary work are performance audits and inquiries, which make up around 10 per cent of the Office's activities. While the financial audit and assurance work of the Office is well established and accepted, performance auditing is still developing and growing in importance, reflecting a significant increase in resources in 2004. Overall, we found a high level of satisfaction with the OAG's performance audits. Interviews with Ministers, Select Committees and public entities yielded a range of generally positive comments. The results of the OAG-commissioned 2007 Stakeholder Feedback Interviews showed all respondents satisfied with the quality of OAG performance audits and 86 per cent satisfied with their usefulness. There was only the occasional questioning as to whether all the subjects covered really warranted scrutiny by the Auditor-General.
- 3.10. We found considerable process rigour around quality assurance, with no fewer than five reviews conducted in the year preceding our own review. These reviews have all commented positively on the OAG's performance audits, while also usefully signposting ways in which further improvement can be made. We note that, at present, much of the quality assurance effort is focussed towards the end of an audit or indeed after an audit report has been published. We consider there would be merit in applying more of this resource to earlier points in the audit lifecycle.
- 3.11. With 14 performance audits to deliver in 2007-08 and a core audit staff of 15 performance auditors, there is a question as to whether present core staffing levels for performance audits provide sufficient continuity and capacity to do justice to the range and number of audits tackled each year. The selection processes for performance audits could also be refined, primarily around a more proactive engagement with Members of Parliament and public entities. While improving quality of audits and recommendations is of prime importance to the reputation and credibility of the Office, there is also the imperative to ensure that recommendations are actually being implemented effectively. A closer working relationship with Select Committees could assist in this respect.
- 3.12. May 2006 saw the introduction of an Inquiries Manual designed to rationalise processes and procedures across the Office, centred upon good practice established in earlier inquiries. The Manual represents an important decision-making tool and is an important means for the Auditor-General to demonstrate, with clear and comprehensive documentation, that processes have been diligently and consistently applied.
- 3.13. In 2006-07, there were two specific quality assurance exercises applied to the inquiries function which identified a number of areas of the Inquiries Manual that might need strengthening, as well as a need in some inquiries for more documentation to properly record key decisions and positively demonstrate compliance with the Manual.
- 3.14. As with the OAG's performance audits, the 2007 Stakeholder Feedback Report found 100 per cent of respondents satisfied with the OAG's handling of inquiries, compared with a figure of 75 per cent in 2006.

- 3.15. Our overall assessment is that the Office has coped well with the challenges of recent years and is performing its tasks professionally and well. It has the feel of an outward-looking and forward-looking organisation. The feedback from stakeholders on its performance was generally positive, as noted earlier, with some suggesting that the Office could do even more to contribute to improving public sector management in New Zealand. We found management and staff alike to be well attuned to the changing requirements and expectations placed on the Office. Both the OAG and Audit New Zealand now seem to us to be well positioned to respond to the further challenges that lie ahead.
- 3.16. As with other Audit Offices and private sector accounting firms, the OAG and Audit New Zealand have an ongoing problem of attracting and retaining suitable professionals not only to undertake audit programmes, but also to maintain – and hopefully improve – research and development capacity, add value to audits and improve relationships with all stakeholders. At least three related factors need to continue to be addressed to meet staffing concerns – providing suitable personal development and professional training as well as state-of-the-art audit tools; providing a comprehensive and varied audit programme that is relevant to stakeholders as well as being demanding and interesting to staff; and promoting stakeholder relationships that enhance understanding and acceptance of the work of the auditor.
- 3.17. The Review Team saw its main tasks as information gathering, assessment, assurance and adding value. Full access was provided to all documentation and relevant personnel both within and outside the Office. The Team had sufficient expertise to undertake all assessments without any other assistance. This reflected both the professional qualifications and the wide experience of individual Team Members. Thus it had full confidence in its ability to provide assurance across the full range of the Office’s activities – of both an audit and a non-audit nature.
- 3.18. The Team considered it would best add value largely by supporting and reinforcing observed better practice. This included offering a number of suggestions for improvement based on Team Members’ knowledge and experience. The opening quote to this overview was a recent reflection of the views of Auditors-General in the United States and United Kingdom, suggesting the need for more audit focus on strategic planning, governance, risk management and performance measurement and reporting. In addition, the Team took into account the increased involvement of the private sector in public service delivery and issues associated with cross-agency delivery of government programmes.
- 3.19. A Draft Report was provided to the Auditor-General for any comments and/or suggestions – basically on facts and accuracy. The final Report includes his comments where relevant.
- 3.20. The following sections of the Report, led by individual Team Members, outline what we found and what improvements we suggest.

## 4. Governance and Management

### 4.1 Introduction

- 4.1.1 Governance has been defined as “...the processes by which organisations are directed, controlled and held to account. It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organisation. It includes how an organisation is managed, its corporate and other structures, its culture, its policies and strategies and the way it deals with its various stakeholders.”<sup>2</sup>
- 4.1.2 The Controller and Auditor-General is an officer of Parliament. His powers and responsibilities are set out in the Public Audit Act 2001. The Auditor-General is independent of executive government and Parliament in discharging his statutory functions but is answerable to Parliament for the stewardship of the public resources entrusted to him. His primary task is to provide independent assurance to Parliament and the public that public entities and local authorities are operating in accordance with Parliament’s intentions and accounting for their performance. The governance issues facing the Auditor-General can be quite complicated – not least because he deals with a wide range of stakeholders in a fast-changing and often complex environment.
- 4.1.3 The Public Audit Act 2001 also sets out statutory status for the position of Deputy Controller and Auditor-General, who is also appointed by the Governor-General on the recommendation of Parliament. It confers on the Deputy position the same powers and many of the responsibilities of the Auditor-General. The two positions were obviously intended to be complementary and mutually supportive, and the Team found that this is how the relationship is working in practice. It was impressed with the sense of partnership that characterises the working relationship between the Auditor-General and Deputy Auditor-General.
- 4.1.4 Recent years have seen significant changes in the accounting and auditing professions as well as in New Zealand’s legislative and operating environment. A new Public Audit Act was passed in 2001. New accounting standards based on the International Financial Reporting Standards which came into effect on 1 January 2007 (earlier in the case of local government) affect virtually all public entities. The Local Government Act 2002 generated major new work for the Office, including the requirement to audit local authorities’ Long Term Council Community Plans (LTCCPs). Stakeholder demands on the Office are rising. More complex and more stringent managerial standards are now imposed on all public entities.
- 4.1.5 The Office has undertaken a major programme of organisational adaptation and improvement in response to these changes. Its annual budget increased from \$36.8 million in 2001-02 to \$69 million in the 2006-07 year. Over the same period the staffing of the OAG and Audit New Zealand has gone from 248 to 288. Strategic planning has been put on a more systematic footing. The contestable model of audit allocation has been replaced by an allocation model. It has developed a new project management unit and a research and development capability. It has merged the strategic planning and corporate service functions of the OAG and Audit New Zealand. Effort has gone into the development of knowledge management, risk management and business continuity frameworks. There is a stronger focus on professional development. An independent Audit and Risk Committee has been established, along with an internal audit function.

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<sup>2</sup> Australian National Audit Office, August 2003. *Public Sector Governance. Better Practice Guide.* Canberra.

Interaction with key external stakeholders has been stepped up. The Office's planning and reporting processes have become more robust and transparent. Numerous external reviews and surveys have been commissioned by both the OAG and Audit New Zealand.

- 4.1.6 In terms of its output, the Office has placed a progressively stronger emphasis on performance and programme audits. Its regular financial audits now involve closer scrutiny of such areas as probity, waste, sustainable development, stewardship of assets and compliance and assessing the quality of service performance information in annual reports. It consults more widely on its discretionary work programme. More attention is being paid to the quality of its reports. A number of good practice guides have been produced aimed at lifting performance in the public sector. Links have been maintained and strengthened with regional and international professional groupings.
- 4.1.7 To give a brief picture of its current situation, the Office is now responsible for over 4000 financial audits and delivers 20 or so other reports per year – around 15 performance audit reports, and several reports on major inquiries, special studies, or good practice guides. It provides some 140 written reports to Select Committees each year - and a similar number of reports to Ministers on the results of annual financial audits. Each year it receives over 300 requests for inquiries. A small number of these result in major inquiries (e.g. 7 in 2005-2006). It engages over 60 external audit providers to carry out annual audits of public entities. The OAG staff numbers are currently about 71, while Audit New Zealand employs some 217 staff. In the Review Team's opinion, this workload requires a strong emphasis on strategic direction and the careful management of risks to the reputation of the Office.

## **4.2 Organisation Structure**

- 4.2.1 The OAG carries out strategic audit planning; sets policy and standards; appoints and oversees auditors; undertakes performance audits; provides reports and advice to Parliament; and carries out inquiries and other special studies. Audit New Zealand undertakes audits allocated to it by the Auditor-General and provides other assurance services to public entities within the Auditor-General's mandate. It also contributes to other OAG work, including inquiries, performance audit and research and development projects.
- 4.2.2 Although technically responsible to the Auditor-General, for many years the OAG and Audit New Zealand operated as quite separate units. The main reason for this was a concern to avoid compromising Audit New Zealand's ability to compete for work against private sector audit service providers under a contestable regime. It also reflected the public sector trend of those times towards separating service delivery from policy and regulatory work. In 2002, the decision was taken to more closely integrate the OAG and Audit New Zealand at a strategic planning level. The move to an allocation model for selecting auditors and the difficulties experienced in maintaining adequate levels of servicing for both units led to a decision in 2006 to merge the two sets of corporate service units into a shared servicing platform.
- 4.2.3 The OAG and Audit New Zealand Business Units are quite different in size and function. One is more a regulatory body, the other a service provider. Each has its own quite distinct operational requirements. For Audit New Zealand, the separate identity helps preserve the advantages of a specialist audit practice in such areas as recruitment, retention and contestability. Moreover, the Audit New Zealand operation is considerably

larger and involves a number of offices spread around New Zealand. Both units operate flat structures that seemed to the Team appropriate to their functions.

- 4.2.4 Both units clearly benefit from being joined “at the head” (through the strategic planning undertaken jointly by their leadership teams) and now “at the feet” (through shared Corporate Services). The current arrangement is generally held to be an appropriate point of balance, allowing each business unit to operate in an appropriate way but, at the same time, ensuring a shared sense of direction and the efficient provision of corporate services. The structures and processes set up since 2006 seemed to all whom we interviewed to be working well. Protocols set out clearly how the relationships are to be managed. Ongoing attention is paid to ensuring that the degree of separation remains sufficient to guard against conflicts of interest but also allows integration or collaboration to be pursued where this holds out real benefits to the Office.
- 4.2.4 Office accommodation in Wellington is of a good standard and staff seemed generally satisfied with their current work environment. However, some importance attaches to bringing the OAG and Audit New Zealand staff in Wellington together under one roof when the lease on the current OAG building expires. The physical separation of the two offices makes communication difficult. We consider that a shared workplace would help foster a greater sense of teamwork and enhance informal communication as well as improve formal coordination. The Corporate Service units should preferably be located alongside both units.
- 4.2.5 We were told that a real estate agent is to be engaged to identify suitable office space for the two units. The preferred time frame for a shift is mid-2009. Our understanding is that staff representatives will be involved in the planning process. It seemed to the team that the move to a common space was of sufficient importance to the dynamics of the two units, and that the task of planning new office space is sufficiently complex, to warrant early attention being given to the establishment of a project team, including staff representatives, to work through the many issues involved in any shift to new premises. It will also be important that the Office be adequately funded for such a move.

#### *Suggestions for Improvement*

- **A task force should be established to carry out planning and preparatory work on the proposed move to a new building housing both the Office of the Auditor-General and Audit New Zealand Business Units. Adequate funding needs to be provided for the move. Regular communication with, and involvement of, all those affected will be important for a successful outcome.**

### **4.3 Governance Framework**

- 4.3.1 The Auditor-General attaches considerable importance to the Office’s governance framework. It is the means by which strategies and policies are set; key risks are identified and managed; performance is monitored; work is coordinated; and appropriate and ethical behaviour is promoted. This is all the more important because the Office does not have the full range of public sector checks and balances on governance: the Auditor-General is a single, statutory officer with both governance and executive functions vested in him and is required to exercise his powers in an independent manner.
- 4.3.2 A comprehensive review of the governance arrangements and systems of the Office was carried out in late 2006 by an independent consultant who was formerly a Public Service

- Chief Executive. Overall, it gave high marks for the standard of governance in the Office, noting that good governance was deeply embedded in the organisation's culture and leadership. Formal processes and actual behaviour were seen to be mutually reinforcing. The Auditor-General noted in his most recent Annual Report that all of the Review's recommended improvements had been implemented or were being addressed.
- 4.3.3 In our view, the Auditor-General provides the Office with a high standard of leadership. There is a strong focus on results, the importance of building relationships, high ethical standards and the need for clear, open communication. The drive for continual adaptation and improvement comes from the top. The leadership culture aims at clear communication of expectations for ethical behaviour coupled with ongoing dialogue with staff. High standards and values are supported by processes and documents which help ensure that these standards are embedded in the organisation's culture.
- 4.3.4 In the absence of some of the usual public sector checks and balances on governance it is important that the Office be run in as open and transparent a manner as possible. The Auditor-General is to be commended for the numerous steps he has taken to open the Office to external scrutiny. These include focus groups, peer reviews, advisory groups, external reviews of performance audits, independent checks on audit allocation decisions and fee levels, consultation with stakeholders on the discretionary work programme, an independent Audit and Risk Committee, climate surveys and external stakeholder surveys. The Auditor-General's annual reports routinely carry an independent report on the audit allocation system as well as a statement from the Chair of the Audit and Risk Committee.
- 4.3.5 In recent years, the Auditor-General has moved to develop more specific measures against which to assess performance in his Annual Report and other accountability documents. A review was undertaken by external management consultants in 2006-07 to try to develop a more meaningful methodology that takes into account the widely varying size and nature of individual audits. The presentation of the Auditor-General's Annual Plan for 2007-08 reflects a move towards greater specification of outcome information and performance measures in the OAG's Statement of Service Performance.

#### **Audit and Risk Committee**

- 4.3.6 A four person audit and risk committee meets four times a year to provide the Auditor-General with the assurance he requires on key internal controls and processes. The Committee was established in 2003 and is composed largely of external appointees, all of whom are chosen for their expertise and experience. Its main functions are:
- risk management and internal control
  - the internal audit function
  - financial and other reporting
  - governance framework and systems
  - compliance with legislation and policy.
- 4.3.7 These functions are set out clearly in the Committee's Charter. The Committee has completed and reviewed a number of reports in the past three years. Our team checked the follow-up action taken and was impressed by the Committee's systematic and thorough approach. The Chair of the Committee confirmed to the Review Team that he was not aware of any significant risks that should be drawn to our attention. A similar assurance is contained in the Auditor-General's Annual Report for 2006-07.

## **Internal and External Audit**

- 4.3.8 The Office's internal audit function has recently been contracted out to a major accounting firm. Previously, it was handled by a staff member - an arrangement which was not entirely satisfactory to either the Auditor-General or the Audit and Risk Committee.
- 4.3.9 We inspected the management reports issued by the Office's external auditor for the past three years. The auditor confirmed that he had looked closely at such issues as probity, waste, legislative compliance and reporting on service performance (i.e. the elements now covered by "enhanced" financial audits) as well as the standard financial management issues. In response to our question, the external auditor confirmed that he had not as yet undertaken a broader performance audit of the Office, although this was allowed for in his terms of reference. He agreed that this was a possibility worth considering. We were told that the OAG and Audit New Zealand were transparent and open to deal with, and that the Office culture was a strong and positive one from an auditor's perspective. The Auditor-General always insisted on a "hard" or "no holds barred" audit, and the Office had invariably taken prompt follow-up action on any recommendations.
- 4.3.10 No major issues were identified in the 2006-07 audit. The risks around IT systems that had been identified in a recent external review were regarded as being managed appropriately. The merger of corporate services was seen as a major advance. Financial management had tightened up and financial controls were up to standard. (This was also the conclusion of a review carried out in June 2007 by Ernst and Young, which commented positively on the improvements made in the areas of Finance and IT in particular.) The project management unit had completed good work on the standardisation of project management tools and disciplines. Formal project specification requirements had been established for all performance audits, major inquiries and research projects. The annual report was seen as accurately and fully reporting on the work of the Office. Its improved coverage of service performance in particular was commended by the external auditor.

### ***Suggestions for Improvement***

- **It is suggested that consideration be given to having a performance audit undertaken of the Office by the External Auditor in the next year.**

## **4.4 Management**

- 4.4.1 The merging of corporate services initiated in 2006 is substantially completed. Both the OAG and Audit New Zealand now draw off common services in the areas of corporate planning, project management, human resources, finance, information technology, communications and reports, legal services and internal audit. By common consent, this arrangement is providing more effective and efficient support than was the case in the past. Managers and staff in both units expressed satisfaction to us about the level and standard of support services now being provided. While there is more to be done in such areas as information technology, the servicing problems that dogged both business units in the past seem now to have been largely resolved. A comprehensive review of the support services provided to Audit New Zealand under the new arrangements is about to commence, as is a review of business support services more generally.

4.4.2 The two remaining areas still to be fully brought together are contracts and document and record management. While a number of contracts have been standardised between the two offices, some service, maintenance and supply contracts have yet to be merged. Work is in train on this. The problem with documents and records management is partly the different systems in use in the OAG and Audit New Zealand (Silent One and Documents One respectively) and partly the difficulty of bringing practices into line with the requirements of the Public Records Act 2005. It is not yet clear whether the two systems will be merged or whether other mechanisms such as the intranet will meet the needs of shared documents and records.

### **Human Resources (HR) Management**

4.4.3 The HR Division was observed to be performing its functions well. Communication with client divisions is of a high standard and the Office's HR policies and practices compare well with those of other public sector organisations. The merger of OAG and Audit New Zealand HR systems is effectively complete, with shared staff, programmes and processes now in place.

4.4.4 The major HR challenge facing the Office at present is in the recruitment and retention of qualified and experienced staff. Several years of sustained economic growth and historically low unemployment mean that financial expertise and audit assurance experience are both in high demand in NZ at the present time. A number of audit staff continue to leave (often to go abroad) after their first three or four years in the job. To compensate for this trend, a number of auditors have been recruited from abroad. A major new recruitment campaign was being launched in the United Kingdom and South Africa as the peer review exercise took place. A recruitment specialist has been contracted in to the HR Unit for one year to manage this area of work. Secondment and exchange possibilities are also being pursued in selected countries. The recently-strengthened intern programme is producing good results, with an encouraging number of interns returning to take up full-time work with Audit New Zealand. In February 2007, 25 new graduates began work with Audit New Zealand. This programme is viewed by Audit New Zealand as a key element in its recruitment strategy.

4.4.5 Remuneration systems and levels are generally seen as appropriate. Remuneration levels are based on the widely-used Hay job evaluation system. A range from 80 per cent to 105 per cent of the market median is most commonly applied, depending on performance. The performance management system has been under revision recently but has a good level of acceptance among managers and staff alike. Regular appraisals are conducted against agreed objectives, using a standard form for staff at all levels. The goals and performance targets for individual employees are derived from unit work plans and well aligned with overall organisational objectives. While the forms differ slightly between the two business units, both require that performance be assessed against agreed targets and have an appropriate emphasis on self assessment, job-related competency evaluation and the identification of personal development needs.

4.4.6 Two superannuation schemes are available to staff: the recently-introduced Kiwisaver scheme and an AMP plan. All Office staff may join the Kiwisaver scheme. A position on the payment of employer contributions into this scheme will be taken once decisions are reached on the application of Kiwisaver to the broader State sector.

4.4.7 The OAG and Audit New Zealand face a major challenge in maintaining the necessary levels of skill and professionalism among their staff. General management and leadership training (including participation in Leadership Development Centre courses)



are being emphasised. Action has been taken on the recommendation in the 2006 report on governance that senior staff be given greater access to guidance on feedback and coaching their staff. Likewise, workshops have been held to implement the report's recommendations on how top managers should discharge their leadership responsibilities. A 360-degree feedback programme has been introduced to inform individual development plans. A specialist contractor was engaged this year to work on leadership and development training. Significant numbers of staff have participated in the Leadership Development Centre's programmes. Senior staff have attended workshops aimed at equipping them with stakeholder relationship and staff management skills. Particular emphasis is placed on individual development programmes and high potential and talent management programmes.

- 4.4.8 The OAG and Audit New Zealand are also putting increased effort into professional and refresher training for their staff. For the past two or three years, the focus has been on providing tailored training courses for the central government legislative changes, the IFRS changes and the LTCCP exercise. There was a significant increase in per capita expenditure on training and professional development in the 2006-07 year. Audit New Zealand has recently reintroduced its national professional development programme for all audit staff. The Office encourages the development and maintenance of appropriate links with professional bodies.

### **Financial Management**

- 4.4.9 Although work is still in progress in some areas following the merger of corporate services, the Finance Unit is seen as performing its tasks to a high standard. A number of staff commented on the improvements achieved since the merger. There now exists one financial management system, one set of accounts and one payroll function. Improvements have been made recently to the system for apportioning overhead costs between the OAG and Audit New Zealand. The 2006-07 external audit report commends the Office for the work done on rationalising the general ledgers and payrolls. Staff interviewed confirmed that the financial information generally met their needs. Financial reporting to the managers and leadership teams is also generally hitting the target. We inspected sample financial reports at both management and leadership level and found them to be of a good standard and useful for decision-making.
- 4.4.10 Audit New Zealand managers consider that they are receiving much improved support and reporting from the Finance team in such areas as fees and budgets. The reconciliation and consolidation of the different financial management information systems previously in use in the OAG and Audit New Zealand is not yet completed, but good progress has been made. A new costing approach is being developed to support the budget and payroll systems. The suggestion was made to us that the team might usefully be strengthened to enable it to provide more support in such areas as contract management.
- 4.4.11 The Office has been successful in securing additional funding for its new work stemming from legislative changes and changes in accounting and audit standards as well as for its increased focus on performance audits and enhanced financial audits. We were told that its current appropriation is adequate for its purposes. Therefore, the primary focus is on establishing appropriate financial priorities, not least across the Office's audit programmes.
- 4.4.12 New instructions have recently been issued on sensitive expenditure. The External Auditor confirmed to us that the Office's financial management and reporting systems

were in good shape. Managers and staff seem well aware of their responsibilities in terms of financial management. The Audit and Risk Committee has conducted a number of reviews of the Office's financial management systems and controls, and we saw evidence of strong follow-up action having been taken on its recommendations.

### **Project Management**

- 4.4.13 The Project Management Unit's responsibilities are diverse and organisation-wide. They encompass risk management; legislative compliance; maintaining the Office's strategic and corporate planning processes; servicing the Audit and Risk Committee; overall performance evaluation; project management methodology; and overseeing the organisation's reporting requirements.
- 4.4.14 In our view, the project management team has done valuable work on the standardisation of project management tools and disciplines. Formal specifications are set for all performance audits, major inquiries and research projects. We viewed the documents relating to the implementation of a legislative compliance programme and were satisfied that it provides positive assurance that appropriate processes are in place and is in line with good practice within the public sector. The Unit is seen by managers and the Audit and Risk Committee as making a valuable contribution to its other areas of responsibility.

### **Risk Management**

- 4.4.15 The importance of an integrated and well-developed risk management policy, including regular reporting against the major risks, was emphasised in the 2006 report on governance. Substantial progress has been made towards this goal, but its completion remains a high priority for the Office. It is important that stakeholders have assurance that the organisation will achieve its objectives without running unacceptable risks. Key to this is ensuring that staff at all levels have sufficient knowledge and appreciation of the risks facing the organisation. It is essential to encourage ownership and commitment throughout the organisation.
- 4.4.16 Risk management is addressed in a number of ways by the Office. We examined the current state of documentation covering the framework. It encompasses strategic as well as operational and business risks for the organisation as a whole. Each unit has its own risk register, and each project proposal is required to be accompanied by a systematic appraisal of risks. Work is in train to ensure the strong involvement of all parties – leadership teams, managers, the Audit and Risk committee and, importantly, individual staff members. Establishing a more standardised and systematic approach to reporting against risks is also a focus. The project management unit, which has central responsibility for risk management in the Office, is conscious of the risk of becoming unduly bogged down in detail and process.
- 4.4.17 The two main strategic risks currently identified are loss of independence and audit failure.
- 4.4.18 The Office's business continuity plan has perhaps suffered from a lack of attention in the past but is now in the process of being updated. It stands to be restructured into three separate parts: crisis management; business unit recovery; and IT service continuity. Use will be made of a business impact analysis to assess the consequences for the organisation of failure in any one of those areas. The timeline for the completion of this

work has the business impact analysis done by the end of 2007, with the plans themselves ready for testing by March 2008.

#### *Suggestions for Improvement*

- **High priority should be given to completing and rolling out the organisation's risk management policy and updated business continuity plan in the current financial year.**

#### **Knowledge Management**

- 4.4.19 Well-established knowledge management processes are important to cushion against the loss of key staff as well as to enhance efficiency and effectiveness by protecting institutional knowledge.
- 4.4.20 The Review Team notes that the 2007 CCH Intelligence Business Survey found that firms with a formal knowledge management programme consistently performed at a higher level as an intelligent business than firms without a programme in place. The significant benefits achieved included 76 per cent reporting increased efficiency and 63-69 per cent improved client service and productivity.
- 4.4.21 The Office has experienced some difficulty in instituting a knowledge management system. Factors such as office layout and different electronic document management systems have militated against it. The electronic document management system is being replaced in the next few months with a more user friendly system that has an appropriate classification framework and will allow the Office to meet its obligations under the Public Records Act 2005.
- 4.4.22 Work is also underway on mapping and documenting the Office's core business processes, beginning with entity management and ASP management. Essentially the "knowledge" comes from staff, although a business analyst has been brought in to facilitate the mapping. This process will be extended across other core business processes in the coming months. Moreover, one of the Office's main information systems – the audit status database (ASD) – is being enhanced. An element in this will be the provision made for stakeholders to add information – for example, about entities and contracts. Finally, the intranet is used as a repository of organisational information on such matters as policies and office news. A "team space" is also being developed to enable groups of staff to share information, documents and plans.

#### *Suggestions for Improvement*

- **The leadership teams should maintain a strong focus on the implementation of a knowledge management system that will meet the present and future needs of the Office of the Auditor-General and Audit New Zealand.**

#### **Corporate Legal Services**

- 4.4.23 The role of the legal team goes well beyond providing specialist services to the OAG and Audit New Zealand. It plays a critical organisational support role. As the provider of legal advice and services to other units, it is clearly doing an excellent job. Managers and staff we interviewed spoke highly of the legal team's responsiveness as well as the quality of its advice. "Always there when needed" was the usual response to our questions. The team will occasionally buy in outside expertise but for the most part

relies on its in-house capability. It has provided first-rate support in new areas of work such as the LTCCP exercise. However, its limited size and dependence on a very small number of highly experienced and able staff represent an organisational risk that needs to be watched carefully.

### **Information Technology**

- 4.4.24 Without exception, managers and staff we spoke with were pleased with the desk-top and help desk services now being provided. Clearly, significant advances have been made in these areas in the past 18 months or so. A major outstanding piece of work however, relates to the two different document management systems in use in the OAG and Audit New Zealand. As noted earlier, the development of an integrated system is complicated by the need to comply with the Public Records Act, the different needs of the two units and the requirement to vary access rules for documents containing information of commercial sensitivity. The case for moving to a policy of restricted access (with open access only where needed) appears to have been strengthened with the merger of the two IT management systems.
- 4.4.25 A recent external audit report on the Office commended the IT team for the improvements effected in the ASD and the Inquiries Database. The IT governance arrangements were deemed to be satisfactory and the further development of the ICT strategic plan was seen as covering off the major issues identified in a previous management report. Regular quarterly reports on the IT/IS plan are now furnished to the leadership teams.

### **Reports and Communications**

- 4.4.26 The Reports and Communications Division has responsibility for exercising quality control over all OAG publications. It is charged with both editing and publishing all OAG reports. This is an important task, given that the reports represent the OAG's "shop front" as well as the main way of getting its views across to a number of audiences around New Zealand. The Peer Review Team was impressed by the quality of the OAG reports and the unit's clear statement of its objectives and performance benchmarks for 2007-08.
- 4.4.27 The group handles press enquiries and media relations, the Office's websites and intranet, and the Audit New Zealand staff newsletter. The latter all looked to be of a high standard and were well regarded by managers and staff alike. The Review Team found them readily accessible and useful. A newsletter for Audit New Zealand's central government clients has recently been restarted. Corporate branding and internal communication channels come within the unit's responsibilities. It also takes an active interest in the provision of training in plain English writing. Presentation and clarity of reports add considerably to the Office's effectiveness.

### **Research and Development**

- 4.4.28 The strengthening of the Office's research and development capability is a good example of the Auditor-General's drive for continual improvement. On the basis of a well researched paper, the leadership team took decisions in May 2005 that led to the establishment and consolidation of a dedicated R&D Unit. Its work derives from the strategic plan and annual plans (notably the drive for product leadership) as well as changes in the operating environment. In its early stages, the unit has been required to develop strategies, methodologies and systems to cope with such developments as the

adoption of IFRS and the introduction of LTCCPs for local government. It is working on the reshaping of services and products to better respond to the changing environment and meet the needs of stakeholders. A new system of ratings has been devised for financial audits, primarily with a view to focussing attention on what areas of activity would benefit from improvement. Standards for the audit of performance information are another area of focus at present. Tracking overseas trends and gathering intelligence also fall within the unit's responsibilities.

### *Suggestions for Improvement*

- **Close attention should be paid to resourcing the R&D function at a level capable of supporting the strategic decision-making critical to the credibility and effectiveness of the organisation, as well as to its ability to respond appropriately to a fast-changing environment.**

## **4.5 Performance Management**

- 4.5.1 The Office's key accountability documents are the annual plan and annual report. The combination of a five-year strategic plan and annual work plans seems to work well. We were impressed by the alignment between the longer and shorter term plans. The plans are well written. Targets and benchmarks are set out clearly. A full range of documents and reporting requirements support the plans. They give clarity of purpose and a strong sense of focus on key objectives. In the words of the 2006 governance report: "The Office has a clear purpose as expressed in its Strategic Plan as well as a coherent strategy to achieve it." Staff are encouraged to participate in the formulation of plans and considerable effort is made to secure their "buy in".
- 4.5.2 The OAG's timetable for the annual plan is a model of its kind. The current five-year strategic plan covers the period up to 30 June 2009. The Project Management Unit is responsible for providing the leadership teams with the tools and information for assessing progress against the agreed strategic direction of the organisation. A first meeting was held recently to begin work on the next five-year strategic plan.
- 4.5.3 A Charter promulgated for the leadership teams sets out clearly their respective roles and responsibilities. The Auditor-General chairs meetings of the OAG leadership team and attends the Audit New Zealand executive management team. Reports kept of these meetings showed evidence of focused strategic thinking and a strong emphasis on results.
- 4.5.4 Combined management team meetings support the leadership teams. The Office uses the full range of internal accountability documents to drive strategy down into more detailed work levels. We were impressed by the coherence of the business unit plans, team plans, and individual performance plans we inspected. All these documents were well aligned to the organisation's strategic goals.
- 4.5.5 Management clearly pays close attention to performance monitoring and to ensuring that organisational capability keeps pace with changing requirements and increasing demands. Most recently, the focus has been on staff recruitment and professional development, project management, and research and development; embedding the shared services model; improving systems and processes; and strengthening organisational and professional capability.

- 4.5.6 The Project Management Unit is charged with responsibility for supporting the leadership teams in developing strategic and operational plans and in tracking progress against the agreed objectives. Structured and regular performance monitoring takes place on a regular basis at organisation, unit and individual levels. The combined management teams meet four times a year to evaluate the organisation's overall performance. A range of performance measures have been identified to help chart progress. We viewed samples of the reports submitted to the leadership and management teams and found them to be of a high standard.
- 4.5.7 One area identified by the 2006 governance review, where improvement was thought possible, was the formalisation and documentation (for example, in strategic planning and performance management documents) of the high values expected in staff behaviour. Accompanying this was a recommendation for a closer, more explicit alignment between strategic plans and individual work plans. Both recommendations were accepted by the Office and are under action.

## **4.6 Culture and Values**

- 4.6.1 Staff morale in both business units seems good, and has obviously improved with the strengthening of support services in the past couple of years. This was confirmed in a wide number of staff interviews. Leaders - and their leadership teams - in both the OAG and Audit NZ are positively viewed by staff. Interpersonal relations and communication between the two business units and between Wellington and district offices seemed to be positive. A number of staff went out of their way to comment positively on the strong emphasis placed by the Auditor-General and Executive Director on ethical standards and the independence of the Office. There is a sense of shared purpose and clear objectives evident in both business units. The leadership and senior management teams operate sound systems both jointly and individually, and information is disseminated as a matter of course to staff at all levels.
- 4.6.2 Both OAG and Audit New Zealand staff have come under pressure in recent years because of major changes in their operating environment and as a result of the turbulence that comes with internal restructuring. We were told that some employees had at times felt under extreme pressure as a result. In addition to the fast-growing workload, a contributing factor may have been that certain managers were themselves overworked and not well equipped to provide staff with the guidance and support needed at a time of far-reaching change. Staff numbers were also a problem. Our impression, however, is that managers are now receiving better professional support and training; that staff retention and recruitment is running better; and that more attention is now paid to the importance of maintaining an appropriate work/ life balance.
- 4.6.3 Recent independently-conducted climate surveys show that staff in both the OAG and Audit New Zealand rate highly in the areas of ethics, values and standards. In both cases scores, overall, were quite good and engagement levels seen as relatively high. The climate survey results were made available to staff through managers, many of whom ran discussion groups around them. Audit New Zealand has since focused on engagement, recognition and performance expectations; and the OAG on strategic directions and staff development.
- 4.6.4 A separate survey done of the Corporate Services staff showed some of the expected results of the turbulence arising from the merger of the two units since December 2006. Not unexpectedly, a number of staff felt uncertain about their future and were unsettled

by the changes. Nonetheless, the overall picture is of a team of people who are highly motivated; have a clear sense of where the Office is heading; and see the Office as a positive place to work. As mentioned earlier, a review is currently underway of the conditions of service for the business support group.

- 4.6.5 So far as external perceptions of staff of the Office are concerned, the recent stakeholder surveys we inspected also gave out generally positive signals. Most ratings were in the “positive” to “very positive” category. The constructive nature of working relationships, sectoral expertise, staff professionalism and the organisation’s general credibility were seen as significant assets.
- 4.6.6 Performance against EEO and other targets seems satisfactory. Gender balance is in line with the State sector generally, and ethnic spread is similar – though the Office continues to have difficulty in recruiting suitably qualified Maori staff. Steps are being taken to ensure that recruitment strategies target the widest possible audience. The general distribution of staff by gender and ethnicity has not changed significantly in recent years. Staff turnover rates are satisfactory, particularly given the demand situation for the skills involved.
- 4.6.7 We examined the Code of Conduct. It seemed to us to cover the ground well and to provide clear guidance to staff on the behaviour expected of them. It is designed to supplement the terms and conditions of employment set out in letters of appointment and employment agreements. It covers such areas of conduct as honesty, discretion, conflicts of interest, non-discrimination, protected disclosures, disciplinary procedures, and care of property and resources. Work is in train on the consolidation and updating of policies in such areas as health and safety and leave, where there remains a lack of consistency across the two offices. A standard protected disclosures process is in place.
- 4.6.8 An Employee Assistance Programme is available to staff. There have been very few personal grievance cases in recent years. Satisfactory action has been taken on a number of recommendations made by the Audit and Risk Committee in the past two or three years on such issues as health and safety policies, leave management, support for study leave, and physical security vulnerability.

## **4.7 External Stakeholder Relationships**

- 4.7.1 The Office’s relationships with key stakeholders are in good shape overall. As noted earlier, recent stakeholder surveys bear out the high levels of satisfaction encountered by the Peer Review Team in their meetings with government agencies, local government and Parliamentary Select Committees. The one exception to this is the strain that has come into the Auditor-General’s relations with political parties as a result of the electoral advertising inquiry – *see below*.

### **Government Agencies**

- 4.7.2 Representatives of government agencies raised standard questions about the Office’s work – for example, the value of certain performance audits, lack of staffing continuity and fee increases. Generally speaking, however, they were positive about the balanced, professional and constructive approach taken by OAG and audit staff. The State Services Commission and Treasury value the work done by the Auditor-General to improve standards of governance and management around the public sector. Working

relationships between central agencies and the Office seem generally positive and productive.

- 4.7.3 A recent stakeholder survey around government agencies showed that overall perceptions of the Office were positive and its staff well respected. Its advice to agencies was seen as useful. The OAG scored well in relationship management, with 89 per cent of stakeholders agreeing that working relationships were well handled. Suggestions for improvement included concentrating on financial audits (and in particular on any misuse of public money) and building greater staffing continuity.

#### **Parliamentary Select Committees**

- 4.7.4 Select Committees rate highly the support given them by the OAG. Given that they have no significant research capacity of their own (and depend largely on published documents, party research units and written responses to questions), they rely heavily on OAG assessments of both the financial health and the general performance of government agencies. OAG sector managers are a key – and valued – link between the OAG and Select Committees. Members of Select Committees are given an opportunity to comment on the Auditor-General’s discretionary work programme each year. The Chairs of the Committees with whom we spoke attached value to the OAG’s performance audits because of the insight they provided into the effectiveness and overall performance of agencies.

#### **The Officers of Parliament Committee**

- 4.7.5 The OPC was generally satisfied with the work of the Office. It expressed concern, however, at the way the recent inquiry into the funding of electoral advertising was handled. While recognising the difficult position in which the Auditor-General had been placed, Committee members voiced criticisms of both the process followed and the inquiry’s outcome. The difficulty of the situation in which the Committee found itself was perhaps the greater because its Chair is at the same time Speaker and Minister responsible for the Parliamentary Service. The Review Team was informed that the Committee would, in the future, be paying more attention to its oversight responsibilities in respect of the Office.
- 4.7.6 This concern with the outcome of the Auditor-General’s inquiry into electoral advertising was echoed by party political leaders and other members of Parliament whom we interviewed - although apparently not in the wider community. While we had no mandate to look at either the inquiry itself or the rights and wrongs of the complaints made, it was apparent that the previously good relationship between the Auditor-General and Parliamentarians had been damaged. Yet, the state of the relationship between the Officers of Parliament Committee and the Auditor-General is of prime importance to the effectiveness of the Office.
- 4.7.7 We were pleased to note that, at officials level, the Parliamentary Service and the Office are working hard to get parliamentary and government advertising rules clarified and restore greater harmony to the relationship. With the next general election looming, the issue of political advertising could cause further problems in the coming months. We consider that it might help if, in addition to his regular meetings with the Chair of the OPC, the Auditor-General and his senior staff were to meet in person with key Select Committees from time to time over the next few months in an attempt to build back better levels of understanding and confidence.



### *Suggestions for Improvement*

- **The Office of the Auditor-General and senior Parliamentary Service managers should continue their efforts to strengthen the relationship between the Office, the Officers of Parliament Committee and key parliamentary Select Committees.**

### **Local Government**

- 4.7.8 The Auditor-General and his staff are highly regarded by local government. The relationship came under a certain amount of strain with the introduction of Long Term Council Community Plans (LTCCPs), but there was a general sense of satisfaction and appreciation for the way the OAG, Audit New Zealand and other Audit Service Providers had worked together with local authorities to bed in the requirements of the Local Government Act 2002. The point was made to us that the Office had had to play the dual role of adviser and auditor in order to get the LTCCP process launched. More generally, the Office is seen by local authorities as knowledgeable about its sector, constructive in its approach, and reasonable to deal with.
- 4.7.9 Local Government New Zealand was similarly positive about the work of the Office. They saw the OAG as a credible watchdog and a constructive partner in improving the standards of governance in local government bodies. This view was echoed by the Society of Local Government Managers, which has an overall role responsibility for improving local body management capability. They saw the OAG team as highly professional, well informed and helpful. They value the support given by the OAG to their efforts to promote and support better management practices in the local government sector. They noted that the Auditor-General had established a Local Government Advisory Group to ensure clear, strong communication with the sector.

### **Professional Contribution**

- 4.7.10 The OAG and Audit New Zealand are significant contributors to the advancement of the accounting and audit professions both within New Zealand and on the international stage - particularly in the South Pacific. Staff, either on behalf of their organisation or in an individual capacity supported by the Auditor-General, are directly involved in the governance of the Institute of Chartered Accountants in New Zealand through the Executive Board and are also active participants in the following:

- FRSB that sets the reporting standards in New Zealand;
- various working groups of the FRSB;
- Professional Standards Board that sets auditing and other professional standards in New Zealand; and
- several committees involved in the Institute's annual report awards.

Similarly, on the international stage, staff from the OAG and Audit New Zealand are involved in the following, a number of which require a significant contribution:

- International Public Sector Accounting Standards Board (IFAC based) that develops, on an international basis, reporting standards for the Public Sector;

- various committees of the INTOSAI, including those contributing to Environmental Auditing and setting Professional Standards; and
- providing the Secretariat of the South Pacific Association of Supreme Audit Institutions, involving various ongoing initiatives and organising the SPASAI conference.

4.7.11 In addition, Audit New Zealand is involved in a number of international secondments and exchanges with comparable organisations in other countries. For relatively small organisations, the OAG and Audit New Zealand make a significant and much respected contribution, both nationally and internationally.

## **4.8 External Performance Assessment**

4.8.1 As indicated earlier, the Auditor-General runs an open organisation and regularly seeks external assessment and validation of the Office's goals and activities. As also noted, good progress has been made in the measurement of, and reporting on, levels of service performance and achievements against strategic goals. This is reflected in comments earlier in this report on the way in which performance is now being reported on in the Auditor General's Annual Report.

4.8.2 Although independent of Parliament and executive government in carrying out his statutory duties, the Auditor-General is responsible to Parliament for his stewardship of the public resources entrusted to the Office. The OPC meets with the Auditor-General and his representatives from time to time to review such matters as the Office's discretionary work programme and the evaluation framework for assessing the impact of performance audits.

4.8.3 An Independence Review Committee provides assurance that the Auditor-General's judgements on independence matters are appropriate, having regard to such issues as stipulated standards and guidelines and his duty to act independently in terms of the Public Audit Act 2001. Following an Audit and Risk Committee review in 2005, processes for staff declarations on confidentiality and independence were tightened up and standardised across the two business units.

4.8.4 Each year an independent evaluation is made – and the results incorporated in the Auditor-General's annual report – of the audit tendering and allocation process. Independent reviews are also undertaken of at least two performance audits a year.

## **5. Financial Statements and Assurance Auditing** *(Section 15 of the Public Audit Act 2001)*

### **5.1 Introduction**

5.1.1 In relation to the Office's assurance activities, the Independent Peer Review Team's Terms of Reference specifically tasked the Peer Review Team to consider:

- the conduct of financial audit engagements, including the audit of Long-Term Council Community Plans and the Controller Function; and
- the allocation of audits and the setting and monitoring of audit fees.

And more generally:

- the operation of the Office's quality control systems; and
- relationships with primary stakeholders, in particular Parliament.

5.1.2 Our report addresses these activities in three segments, the financial audit, including the operation of Audit New Zealand, the audit of the Long-Term Council Community Plans and, finally, the Controller Function.

## **5.2 Financial Statements Audit**

5.2.1 The Controller and Auditor-General's mandate and responsibilities are set out in the Public Audit Act 2001. Among a range of matters relating to the abovementioned issues, the Act specifically provides for:

- the Auditor-General to be the auditor of every public entity (*section 14*);
- the Auditor-General must from time to time audit the financial statements, accounts and other information that a public entity is required to have audited (*section 15*);
- the Auditor-General may at any time examine a public entity with respect to its activities with a view to establishing if it is:
  - operating effectively and efficiently;
  - operating in compliance with its statutory obligation;
  - operating in a wasteful manner; and
  - operating with a lack of probity or financial prudence (*section 16*); and
- the Auditor-General may, with agreement of an entity, provide other auditing services that are reasonable for an auditor to perform. (*Section 17*).

5.2.2 In addition, and of relevance, section 23 requires the Auditor-General to publish the auditing standards that the Auditor-General applies, or intends to apply, to the conduct of audits and inquiries, and the provision of other auditing services.

5.2.3 The Auditor-General may appoint:

- an employee of the Auditor-General, a person qualified to be an auditor of a company, or a partnership to carry out the functions under sections 15 or 17; or
- any person who in the opinion of the Auditor-General is suitably qualified to carry out functions under sections 16 or 18 (*Inquiries*).

5.2.4 The Auditor-General may charge fees for the provision of services under sections 14, 15, 16, and 17.

- 5.2.5 The Auditor-General's outcomes framework has three output classes, the first of which is the 'Provision of audit and other assurance services' which relates to the Auditor-General's statutory duty to carry out annual audits of the financial reports of, and in some cases performance information about, 4000 public entities. The class involves the following activities:
- annual and other statutory audits;
  - auditor appointments and fee monitoring of annual audits; and
  - quality assurance of annual audits.
- 5.2.6 The annual audit accounts for about 87 per cent of the Office's total expenditure and produces two main products:
- the audit report provided to the users of an entity's financial statements and performance information; and
  - the management report addressed to the entity's governing body and management setting out any significant issues identified by the Appointed Auditor during the audit.
- 5.2.7 The Auditor-General contracts with individuals (Appointed Auditors) from Audit New Zealand and private sector firms (Audit Service Providers). The Appointed Auditors are personally accountable for the quality of audit work performed. This is largely done on an allocation basis, rather than through some competitive approach (e.g. public tenders). Significant attention is given to ensuring the associated audit fee is fair to both the public entity and the appointed auditor.
- 5.2.8 As the Auditor-General ultimately retains responsibility for the audit of all public entities, a comprehensive quality assurance program of all Appointed Auditors is in place to ensure audits are performed effectively and efficiently and in accordance with relevant professional standards.
- 5.2.9 The outputs from this class contribute to another class, 'Parliamentary Services', which involves using the collective knowledge and wisdom of the Office to provide advice and assistance to Select Committees and other stakeholders. Much of this contemporary knowledge of all public sector entities is gained during the annual audit. Besides annual audits, the knowledge is also gained from general entity/sector intelligence gathering done through sector manager relationship responsibilities, as well as from performance audits and inquiry work.
- 5.2.10 The main measures of performance for the output class 'Provision of audit and assurance services' relate to timely completion of an entity's financial report, reductions in the number of qualified opinions, increased acceptance of Audit New Zealand's recommendations, and improvements in the measures of performance in central government.

### **5.3 Business Model**

- 5.3.1 As already noted, the Auditor-General's staff are organised into two business units, the OAG and Audit New Zealand. For financial audits, the OAG carries out audit planning; sets policy and standards; appoints Auditors and oversees their performance; and provides reports and advice to Parliament. Audit New Zealand, which is the Auditor-General's largest Audit Service Provider, carries out annual audits allocated by the

Auditor-General and provides other assurance services to public entities within the Auditor-General's mandate.

### **Office of the Auditor-General**

- 5.3.2 Within the OAG, responsibility for the achievement of the annual audit outcomes rests with the Accounting and Auditing Policy team, who have developed their own Management Plan to supplement and support the Auditor-General's Strategic Plan. The team's key functional responsibilities include accounting policy, auditing policy, quality assurance, school audit and auditor appointments. That team sees itself as the "professional conscience" of the organisation in terms of compliance with accounting, auditing and other professional standards (Quality Assurance) across the range of products produced by the Office. It also plays a significant and influential role, with Sector Managers, in determining the scope and breadth of the annual audit.
- 5.3.3 It would seem that, in recent years, the team has had difficulty in obtaining, developing and/or retaining the capability it needs to fully and effectively support the roles expected and required of it. While this is somewhat understandable in the current international and local labour market for appropriately qualified and experienced professional personnel, the Peer Review Team was pleased to note that resourcing is now close to full complement and, more importantly, was particularly impressed with the overall quality and capability of the team. Undoubtedly, the ability to retain or replace such key staff involves a significant risk for the OAG.
- 5.3.4 The annual audit, as defined by the Office, differs in a number of not insignificant ways from the audit of a private sector organisation's annual financial audit and also from that undertaken by comparable public sector audit institutions.
- 5.3.5 In part, this enhanced audit is a direct consequence of Parliament's intent as expressed through legislation, such as the requirement to form a view on the Statement of Service Performance while other influences appear to be largely determined by the OAG. Broadly speaking, the latter fall into three categories:
- defining public interest in the accountability of the public sector in a unique and wider manner (enhancing transparency);
  - inclusion of aspects of the performance audit mandate into an annual program of audit (enhancing frequency of coverage and performance); and
  - pursuing specific interests of the Auditor-General, particularly directed at lifting the bar on public sector performance (enhancing performance).
- 5.3.6 This is achieved through requiring Appointed Auditors to comply with the Auditor-General's Auditing Standards and to carry out audits in accordance with some very specific instructions issued annually by the Auditor-General. The latter are called Audit Briefs.

5.3.7 The Auditor-General's Auditing Standards are based on Institute of Chartered Accountants of New Zealand ethical and professional standards which apply to auditing in the private sector. The Auditor-General has expanded those standards to provide some additional standards and additional specific instructions in the application of components of other standards. As a consequence, the requirements placed on the Appointed Auditors are greater and more detailed than in the private sector. Additional standards exist in relation to:

- AG-1 Reporting to the Auditor-General (supporting the overall statutory functions of the Auditor-General and the Office's advice and reporting to Parliament);
- AG-2 Appropriations Audit and Controller Function (setting out the requirements for these unique statutory public sector tasks);
- AG-3 Performance, Waste and Probity (prescribing how some aspects of the performance audit mandate is to be incorporated into an annual audit); and
- AG-4 Audit of Service Performance Reports (setting out how auditors should discharge the statutory requirements on the audit of this information).

5.3.8 Audit Briefs are prepared and updated annually by the OAG and provide detailed guidance and impose specific requirements on Appointed Auditors to supplement the financial audit at each public sector entity. Separate briefs are prepared for a wide range of 'industry' sectors that comprise the Auditor-General's client base. Currently, some 20 briefs are prepared covering 'sectors' such as the following:

- Energy Companies
- Government Departments
- State Owned Enterprises
- District Health Boards
- Port Companies
- Cemetery Trusts

The audit briefs also help ensure that a consistent approach on particular issues is taken by all Appointed Auditors.

5.3.9 Topics to be incorporated within each brief are determined by the OAG consistent with its assessment of the requirements and priorities applicable to each 'industry' sector. Some topics may be included in every brief prepared, while others may appear only in some briefs, or in just one. Individual topics appear to have their genesis in the following requirements:

- to further reinforce and highlight important aspects of the Auditor-General's Auditing Standards;
- to seek specific information on aspects of an entity's operations of interest to the OAG;
- to direct specific audit work/investigation on aspects of an entity's operations of interest to the OAG;
- to require additional work to facilitate the clearance procedures for the consolidation of the Government's Financial Statements; and
- to prescribe reporting requirements, both in terms of topics of specific interest and generally on the overall annual audit outcomes.

- 5.3.10 In excess of 50 topics have been identified for inclusion in the current round of briefs, but it would seem that the maximum number that might appear in an individual brief is in the order of 25-28 topics.
- 5.3.11 As discussed elsewhere in this report, the OAG issues, from time to time, good practice guides covering a range of topics in which it has a specific interest and expertise. Interestingly, some of the instructions included in audit briefs specifically require Appointed Auditors to review and audit aspects of an entity's operations that are covered by such a guide, using the guide as a normative model against which to assess performance. This mode of operations creates the risk that the OAG effectively becomes, or is seen to become, the policy setter in such matters and raises questions about audit independence. The OAG advises that care is therefore taken to ensure that, so far as possible, the guides set out generally accepted and agreed standards for the sector (e.g. through detailed consultations with relevant agencies) and are written at a level of principle rather than as 'detailed' rules to enable entities to adapt them to their own circumstances. The Peer Review Team does not consider this apparent conflict of interest to be a major issue in the New Zealand context.
- 5.3.12 While no hard data was available to the Peer Review Team, anecdotal evidence provided in discussions with a range of stakeholders suggested that the impact of the requirements for the enhanced audit is a significant percentage addition to the cost of an annual financial statement audit. Based on figures suggested by a range of various Audit Providers and Audit Clients, this could amount to several million dollars in any one year. However, the OAG disputed this conclusion, indicating that any addition would be likely to be less than 5 per cent. Moreover, it would take considerable effort on their part to assess such a figure.
- 5.3.13 It was also suggested to the Peer Review Team that there was a tendency for the audit briefs to expand over time; described as brief creep. The OAG's staff advised that this issue had been recently recognised and addressed by a review and revamp of the internal brief preparation process. The Peer Review Team did sight evidence of a new and seemingly more robust process but it remained unclear, with the mix of responsibility between Sector Managers and the Accounting and Auditing Policy Team, if anyone directly responsible to the Auditor-General had, or was able to have, an overall and holistic view of the entire process and outcomes. The OAG has advised that as the 'owner' of the annual audit product, the AA-G - Accounting and Auditing Policy is responsible for ensuring 'brief creep' does not occur beyond the bounds of the Auditor-General's expectations of a public sector audit and processes to reinforce that will be strengthened.
- 5.3.14 Although the Peer Review Team would generally be supportive of the direction, scope and breadth of the enhanced audit in the public sector, it was not evident that this had been subject to recent scrutiny and evaluation by the OAG and/or external stakeholders, particularly the Parliament. The direction, scope and breadth of enhanced financial statements audit in the public sector should be addressed as a matter of priority by the OAG in relation to its own performance and for the information of its stakeholders, particularly the Parliament.

### *Suggestions for improvement*

- **The retention and recruitment of a small number of key staff is a risk that needs to be specifically covered in the Risk Management Plan for the Office.**
- **The direction, scope and breadth of the enhanced financial statements audit in the public sector should be evaluated as a matter of priority by the Office of the Auditor-General in relation to its own performance and for the information of its stakeholders, particularly Parliament.**

## **5.4 Audit Appointment/Allocation**

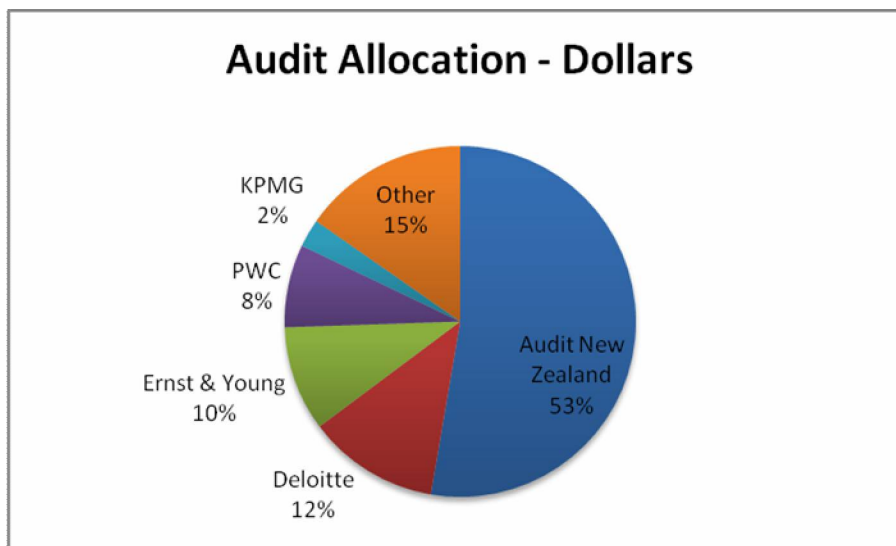
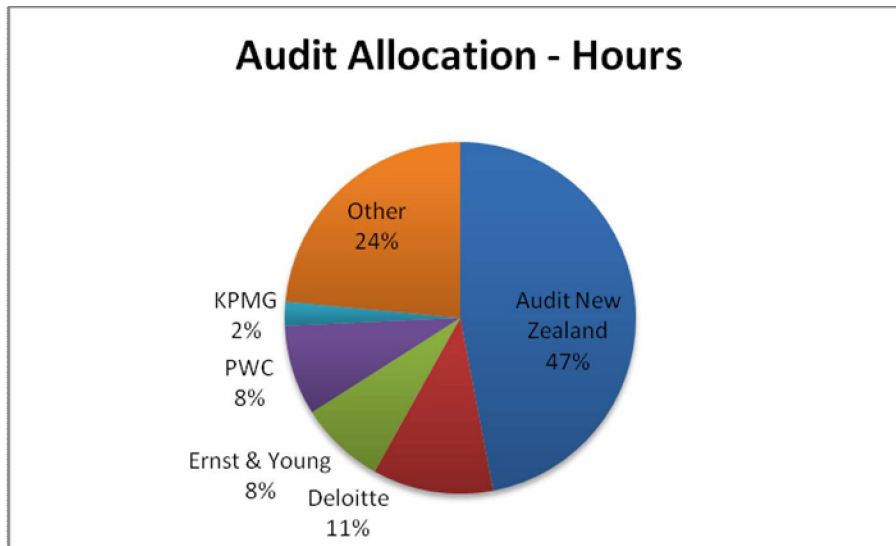
5.4.1 The Australasian Council of Auditors-General Peer Review of the New Zealand Audit Office reported in August 2001 that *“the Office of the Auditor-General should undertake a formal analysis of the cost/benefit of the contestable regime.”* In describing the contestable regime that report noted *“In 1992, as New Zealand was undergoing extensive public sector reform, the then Auditor-General introduced a system of contestability for public sector auditing. Audit New Zealand was separated and ‘ring fenced’ from the Office of the Auditor-General and was required to compete for audit assurance work with private sector audit service providers. However, at that time the Auditor-General signalled his intention to retain some in-house capacity to undertake audit assurance work and reserved the right to withhold the audit of some public entities from the contestable model.”*

5.4.2 Subsequently, after review, including extensive consultation, the OAG changed the principal method of awarding contracts for audits of public entities. This changed the process from one that was based mainly on an option of contestable (*tendered*) contracting to one where most audits of public entities are allocated to Audit Service Providers on the basis of a set of principles/criteria. This process has now been in place for a number of years. The set of principles, listed in the “Report on the Review of the Allocation Model”, comprise the following:

1. *The Auditor-General’s independence will be maintained*
2. *The Auditor-General will allocate audits to Audit Service Providers which satisfy the Auditor-General’s auditing standards and have the capacity and experience to hold a viable portfolio of audits in the sector*
3. *Allocations will involve critical masses of audits in sectors to enable Audit Service Providers to justify their investment in regular sector specific training and development*
4. *The total work allocated to private sector Audit Service Providers will not be less than the current level under contestability (subject to audit quality being maintained), but the allocation process may involve the loss of a specific audit or audits in a particular sector, and a growth in other audits or sectors*
5. *Allocations will take geographic concentration into account, to enable the development of “centres of excellence” by Audit Service Providers at specific locations*
6. *The need for the ongoing viability of Audit New Zealand will be taken into account, while recognising that the initial allocation will entail some reallocation of audit engagements from Audit New Zealand to private sector Audit Service Providers*



7. *Allocations will be grouped to ensure, as far as possible, that they are practical, cost effective and maintain audit quality*
  8. *Opportunities will be created for collaboration between Audit Service Providers*
  9. *Initial engagements will be for terms of two to four years*
  10. *Appointments will continue to be subject to the Auditor-General's regular quality assurance reviews.*
- 5.4.3 As a consequence, most audit appointments are now made by direct allocation after consultation with a representative of the relevant governing body and/or Chief Executive. In some cases an audit tender process may still be used. Generally, this is likely to be confined to large public entities with a commercial focus where the OAG considers it appropriate and also in the schools sector if the Board of Trustees considers it appropriate. Appointments are normally made for three years and are generally rolled over with the same firm at the expiration of each period where performance has been satisfactory and fee negotiations are satisfactorily resolved. Notwithstanding that the individually approved Appointed Auditor will move off particular tasks in accordance with current industry practice, it has become the norm for firms to retain an audit for an extended period of time. With some entities approaching 12 or more years with the one audit firm, the Peer Review Team questioned the absence of a specific policy to address whether this is good practice. We note, for example, that a number of studies have shown a link between the length of tenure of an audit firm and the diminished efficiency of an audit.
- 5.4.4 The Peer Review Team was advised it was common practice in the New Zealand private sector not to change auditing firms. In other jurisdictions it would not be uncommon to test the market for alternative audit service providers from time to time. In addition, the Peer Review Team considered that there would, on occasions, be genuine circumstances where an entity might wish to seek the services of an alternative auditing firm for a better overall outcome. While the OAG's current policies would permit that to happen, this option did not appear to be widely known to those who might wish to pursue it.
- 5.4.5 In conjunction with the operation of the allocation model, the Auditor-General has commissioned Mr David Gascoigne, on an annual basis, as an independent evaluator of the basis upon which audits are allocated to Audit Service Providers. His reports are published in the Office of the Auditor-General's Annual Reports. In 2007, he concluded that the processes in place *"have been appropriate for their purpose, and have been applied in a way which has been consistently fair and appropriate, having regard to the rights, interests and obligations of the parties concerned."* He also noted *"that the processes by which audits in the public sector have been allocated and fees have been set in the financial year to 30 June 2007 have been carried out with due probity and objectivity."* In addition, an internal review of the Audit Allocation model completed in August 2007 identified a number of general, as well as some specific, issues for ongoing attention by the OAG but concluded, overall, that the move to the model *"has a beneficial outcome."*
- 5.4.6 The following charts show the current allocation of work among Audit New Zealand, the four major accounting firms and other private sector Audit Service Providers. At the time of the last Peer Review, mentioned above, Audit New Zealand held some 61 per cent of the work load by hours, and the private sector 39 per cent. In 2007, Audit New Zealand's share of the work (in hours) had reduced by some 14 percentage points to 47 per cent.



- 5.4.7 It was apparent that the set of principles established to underpin the operation of the Audit Allocation model has now evolved into a list of criteria that is used in the selection of an Audit Service provider for the audit of each entity. In discussion with relevant OAG staff, the Peer Review Team was advised that a process is in place to work through the established criteria prior to putting a formal submission to the Auditor-General recommending the appointment of a nominated Appointed Auditor. The Peer Review Team was unable to sight evidence of this process.
- 5.4.8 In discussing the Allocation Model with a wide range of stakeholders, the Peer Review Team was advised that the process had support among Audit Service Providers and public sector entities and was generally a preferred model over the prior contestable model. There was some concern noted at the Central Government level that the current model limits the attainment of the benefits that might be expected to be achieved with a more market orientated approach. In addition, it is important to note the responses to the Peer Review Team’s interviews were provided by those who were participants within the system. Those who are outside the arrangements may have a differing view and it is incumbent on the OAG to ensure, and be seen to ensure, that new

participants can reasonably enter the system and that barriers to entry are legitimately limited to issues of qualification and performance.

5.4.9 Overall, the Peer Review Team endorses the current approach but does note that there are some areas of risk to the OAG that need effective ongoing management. In particular, these include the need:

- to document criteria for determining allocations and then document the reasons for individual decisions;
- to ensure that there is a strong and effective fee management and monitoring arrangement in place (discussed below);
- to develop and articulate how the plan handles allocations into the longer term future; and
- to ensure (in appropriate circumstances) that scope exists, and is known to exist, for entities to test the market from time to time for alternative Audit Service Providers.

5.4.10 The Peer Review Team understands that the Audit Allocation Model would not sit comfortably with the Government's procurement policy which includes a focus on an open and competitive process. This is an aspect which the OAG addresses in its annual audit of a number of public sector entities. The Review Team was advised by the OAG on this matter as follows:

- The allocation model is broadly consistent with the government's general procurement policy, which dovetails with good practice advice produced by the OAG. Those general policy statements acknowledge that, at times, it will be more practical and cost effective to procure without a tender process.
- The model is not consistent with the mandatory rules on procurement for government departments, which were developed as a result of free trade commitments. These rules do not apply to the Auditor-General and are not designed with this office in mind.
- The OAG has been careful to document fully the rationale for departing from a competitive process, to incorporate steps to benchmark prices, so far as possible, and to review the operation of the model regularly.
- The OAG view is that the current model enables it to appropriately safeguard quality and control in the way in which private sector auditors carry out statutory functions in the name of the Auditor-General, while maintaining a price discipline through other means. Parliament and other stakeholders are regularly briefed on the allocation model to ensure that they understand why a tender process is not used and to provide an opportunity to discuss how it is working.
- Therefore, while there will always be a risk of criticism for not using an open competitive process for this work, the OAG actively works to manage that risk.

#### *Suggestions for improvement*

- **It is suggested that the Office of the Auditor-General address the issue of public sector entities having the same Audit Service Provider for periods approaching, and exceeding, twelve years in the interests of preserving audit independence and maintaining the efficiency and effectiveness of the entities concerned.**

- **It is suggested that, in the selection of Appointed Auditors, the assessments against each selection criterion should be documented and summarised in the relevant submission to the Auditor-General.**
- **It would be prudent for the Office of the Auditor-General to minimize the risks associated with being seen not to comply with the main requirements of the government’s procurement policy.**

## **5.5 Audit Fee Setting and Monitoring**

5.5.1 Under an Audit Allocation model and in the absence of ‘normal’ market pressures, audit fee setting and monitoring are likely to assume greater importance than might otherwise be the case. At the start of new audit appointments, or at the point of renewal of an existing contract, Appointed Auditors and entities are given the opportunity to negotiate audit fees for the period of the contract (normally 3 years). However, in some circumstances the period may be limited to 12 months. The Public Audit Act 2001, at section 42, requires the fee to be reasonable, having regard to:

- the nature and extent of the services provided;
- the requirements of the Auditor-General’s auditing standards;
- the qualifications and experience of the persons necessarily engaged in providing the services; and
- any other matter the Auditor-General thinks fit.

5.5.2 Prior to discussing proposed fees with an entity, Appointed Auditors are requested to present a draft proposal to the OAG for, among other matters, a preliminary assessment as to the reasonableness of the proposal. Appointed Auditors are encouraged to provide entities with detailed background on factors driving any proposed fee increase. In the absence of an agreement on fees after reasonable negotiations, either party may request the OAG to provide a formal analysis of the data drawing on its overall knowledge of fees. It was indicated that only 2-3 per cent of cases reach the stage where a formal analysis is requested. The analysis is provided to both parties. If agreement still proves elusive, the Auditor-General can use his powers under the legislation to set a fee which will become binding unless changed by arbitration. This power is rarely used, with only one instance being identified in the recent past.

5.5.3 At much the same time as the introduction of the Audit Allocation model, there was a general national and international upward movement in audit fees. Primarily, this occurred through increased scope of audits as a result of legislative and international standard changes, partly attributable to international market failures, the rising cost of professional indemnity insurance, and sharply increased salary costs for audit personnel.

- 5.5.4 In 2006, the OAG commissioned Rutherford Sloan Ltd to undertake “*an independent review of the processes used by the Office of the Auditor-General to monitor and moderate the audit fees applicable for approximately 4000 public entities.*” They were required to:
- review the work developed to date relating to the Office of the Auditor-General’s audit fees monitoring mechanisms;
  - gather the expectations of external stakeholders including Treasury and SOLGM (Society of Local Government Managers); and
  - advise where the Office of the Auditor-General can make further improvements.
- 5.5.5 Overall, Rutherford Sloan concluded “*We are of the view that the fee monitoring mechanisms, whilst capable of some modest enhancement and refinement, are performing their function in an appropriate manner and delivering against the objective of fair and reasonable audit fees.*”
- 5.5.6 The Peer Review Team was of the view that the quality of information the OAG provides to parties having difficulty in reaching agreement on fees was relevant, seemingly of an acceptable quality and well presented. The Peer Review Team noted the data used to support this function was drawn from a variety of sources, including various desktop spreadsheets, not necessarily routinely maintained and with some considerable reliance on ‘corporate’ memory. The Peer Review Team is very supportive of the OAG’s current plans to build a database and model to facilitate the modelling of audit fees on a more rigorous and sound basis than currently exists. The Auditor-General’s Annual Report for 2006-7 noted that specific actions currently being progressed included:
- *‘improving the documentation of the current fee monitoring processes of the office;*
  - *enhancing the tracking of the main drivers of audit costs (for example, auditor salaries); and*
  - *continuing and expanding many of the processes already in place (for example comparing audit fees by sector using size proxies to identify fee outliers).’*
- 5.5.7 Fee setting and monitoring was regularly raised in the Peer Review Team’s discussion with stakeholders interviewed, particularly those representing public sector entities. They conveyed the general view that they had little or no effective role in the fee setting process and often saw themselves as price takers. While this had not resulted in any significant expressed concern with the level of fees being charged and as such was not deleterious to the entity’s relationship between the auditor and/or the OAG, it creates the risk of such concerns arising in the future. The Peer Review Team accepts the fee setting process, as described above, as a reasonable approach, but notes that effort needs to be directed to ensuring entities are fully conversant with the process and their ability to have an appropriate involvement in the process is well understood and encouraged.

## 5.6 Annual Audit Performance

- 5.6.1 The OAG is involved in a number of formal interventions with Appointed Auditors in the latter's execution of individual audits. The more significant of these are:
- setting auditing standards and tasking Appointed Auditors through the audit brief (as previously discussed);
  - advising on significant and/or emerging accounting and auditing issues;
  - considering proposed qualifications to audit opinions; and
  - maintaining a comprehensive quality assurance program.
- 5.6.2 From time to time, the OAG will be approached for advice on complex accounting and audit issues arising out of individual audits. Normally, this would not be expected to occur until the Appointed Auditor has fully considered the issue, including consulting their own technical advisors. In addition, it would be expected that their approach to the OAG would include a considered view and a recommended course of action. The OAG would then be using its own sources and advisors to develop its approach to the issue, and the proposed course of action. This sequential process would be followed irrespective of which Audit Service Provider is involved. Consideration might be given to whether this is the best business model for issues arising within Audit New Zealand where it seems it may create some duplication of effort and a sub-optimal allocation of resources under the control of the Auditor-General.
- 5.6.3 The OAG has a strong and comprehensive Quality Assurance policy encompassing all the Office's products, including the annual audit. The extension of the policy to encompass all the Auditor-General's products is a recent initiative. The focus of the annual audit QA program is on each Appointed Auditor and targets coverage of all such Auditors once every three years with a priority given to new appointees, those with previously identified concerns, and those where issues may be identified through another mechanism. The program is well planned and executed with onsite visits and follow-up action as necessary. In addition, common issues emerging from the QA program are advised to all Appointed Auditors that they may, as applicable, learn from the process.

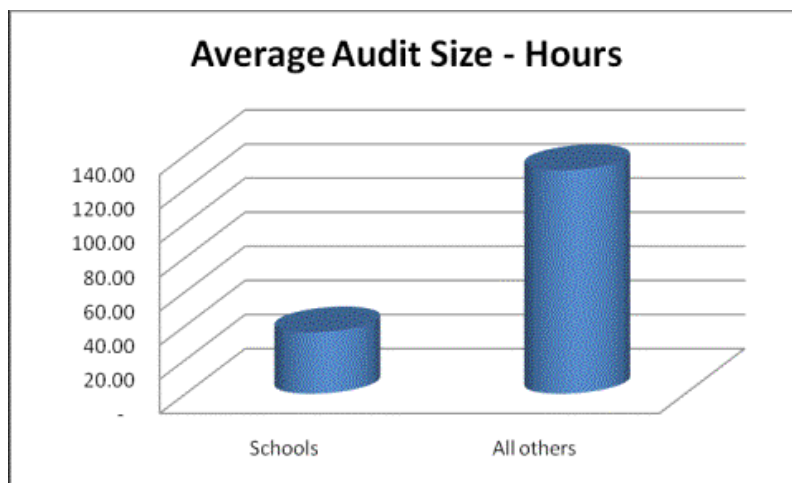
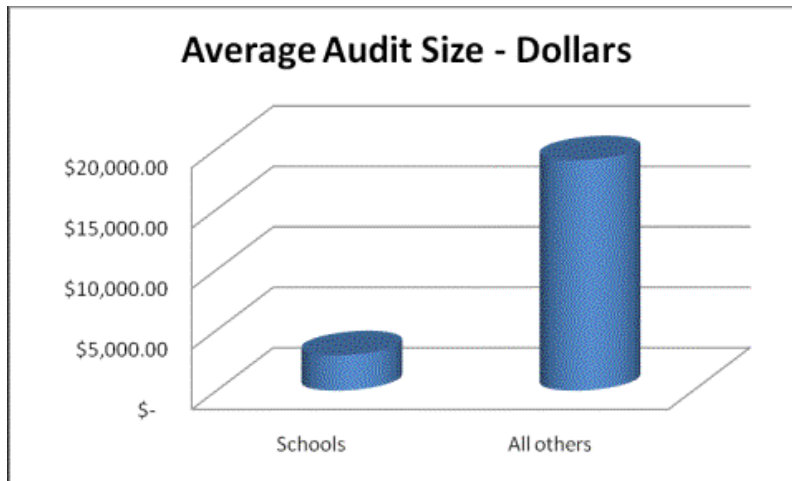
### *Suggestions for improvement*

- **The desirability of merging at least some of the technical resources of Audit New Zealand and those of the Office of the Auditor-General should be further investigated for better operational effectiveness and efficiency, particularly where the skills involved are difficult to recruit and retain.**

## 5.7 Schools Audits

- 5.7.1 Issues associated with the quality of schools audits have received particular attention within the OAG in the last two years. Of the approximately 4000 annual audits undertaken, 2457 are classified as school audits which, apart from the number involved, tend to be very small and widely dispersed around the country. The following two charts compare the size of the average schools audit with the average size of all other audits. Only four schools audits have an input of 100 hours or more and over 1000 of the audits have an input of fewer than 4 person days. In addition, the average cost of staffing school audits is approximately \$81 per hour, while for all other audits it is in the order of

\$145 per hour. At present, there are some 60 Audit Service Providers operating in the school sector ranging from large national firms to small regional practices. It is also a sector where the quality assurance process indicates the quality of the audits reviewed is not consistently as good as in other sectors.

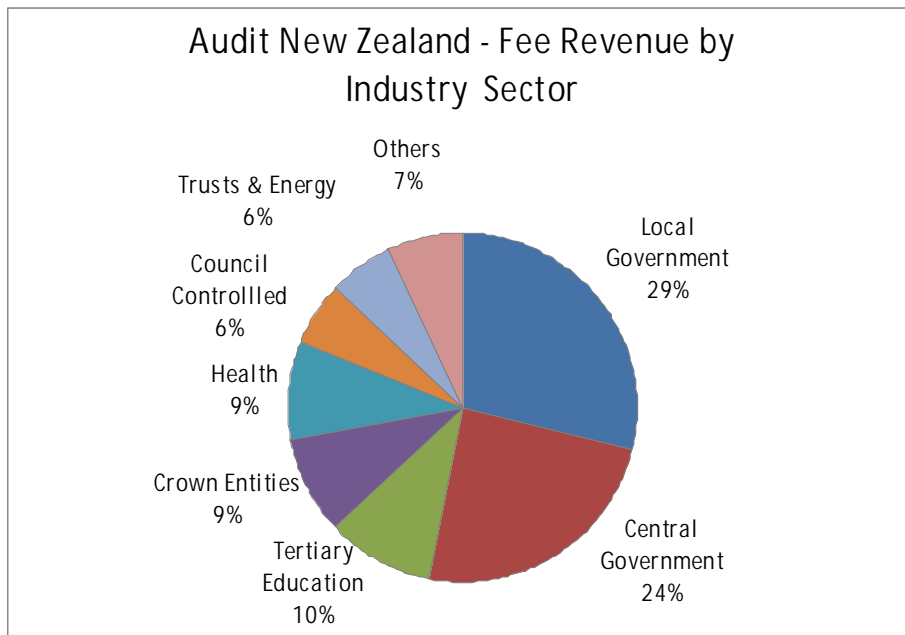


5.7.2 There appear to be some tensions between the completion of the enhanced audit referred to previously and the resources actually available to schools and the quality of the audit process. The Peer Review Team notes the current audit brief for the schools sector is in excess of 90 pages of additional instructions and/or guidance to Appointed Auditors and considers this is likely to exacerbate the tensions noted above. Consideration should be given to encouraging greater participation in the audit approach being taken and simplifying the processes involved.

## **5.8 Audit New Zealand**

- 5.8.1 Audit New Zealand is a separate business unit operating under the Controller and Auditor-General of New Zealand. It is responsible for carrying out annual audits of public entities (also referred to as “enhanced audits”) and for providing specialised assurance services with respect to governance, risk, contracting and project management.
- 5.8.2 Audit New Zealand has approximately 217 staff, structured along functional and sectoral lines, working from seven different locations. All staff are provided with wireless laptop computers, mobile phones, secure wireless access and encryption software for the key working paper files (TeamMate and the document management system).
- 5.8.3 In addition, staff are provided with a national training program based on identified competencies. These competencies are described for each position; job descriptions are up-to-date; and there is a mentoring program for new employees. New staff also receive appropriate training and professional development to allow them to understand the Audit New Zealand structure, methodology, policies and procedures.
- 5.8.4 There has been good attendance at national training program events. Audit New Zealand also monitors compliance of staff with professional development requirements of the Institute of Chartered Accountants of New Zealand by way of self-reporting. Audit New Zealand also has an adequate process in place to ensure that all staff maintain professional independence as required by professional bodies. Staff are required to complete an employee independence declaration form every year.
- 5.8.5 Audit New Zealand, however, has been experiencing a high percentage of staff turnover per year; therefore, recruitment and retention has been identified as a key challenge, particularly at the senior auditor and manager level. Nevertheless, during the interviews conducted by the Peer Review Team, the audit staff felt that a key part of the success of Audit New Zealand was the culture and good camaraderie created in the office. Audit staff felt that Audit New Zealand was competitive from a benefits and salary perspective while offering a broader exposure to accounting and auditing issues. Staff suggested additional opportunities for exchange with other national audit offices as an enhanced marketing tool that could assist in competition with the private sector firms - exchanges which would be part of a more formalised arrangement than exists at present. The OAG acknowledged the need to have formal two-way exchange programmes rather than the ad hoc manner in which the past exchanges have been working.
- 5.8.6 Peak workloads at Audit New Zealand are during the period of April-November and they are well managed. To accommodate peak demands, Audit New Zealand encourages use of time off in lieu; more planning and interim audit work in advance; filling gaps with other assignments; attempting to rely on internal controls if possible; and arranging for the use of staff from private sector firms. They also have outsourcing arrangements with audit offices overseas which provide a few individuals annually during their busy periods. Retention has improved over the last 18 months.
- 5.8.7 Audit New Zealand has approximately 750 audit clients. The following chart shows the allocation of fee revenue among the various client sectors. The main client sectors are the same as the sectoral groups previously mentioned.





- 5.8.8 Annual audits are allocated by the Auditor-General to Appointed Auditors from private sector accounting firms and from Audit New Zealand. From the OAG’s perspective, they treat Audit New Zealand as they would any other Audit Service Provider and therefore expect it to comply with any Audit Briefs issued and to meet the Auditor-General’s audit standards. A discussion regarding the allocation model and its impact on the OAG is provided under the sub-section 5.4 Audit Appointment/Allocation.
- 5.8.9 Before 2004, as indicated earlier, audits were allocated under a contestability model in order to enforce a level of efficiency within the audit process and to “right size” the operations of Audit New Zealand. Around the same time, a number of significant international changes occurred in the accounting and auditing profession due to major failures of private companies, for example, in the US, Italy and Australia. As a consequence, the auditing world saw an increased expectation from auditors with respect to the nature of their services. The difficulty for Audit New Zealand was that it had responded to the contestability regime by reducing its level of investment in training, audit tools, audit methodology and quality control so that it could ensure a cost structure that was lower than that of the private sector. The outcome was that Audit New Zealand achieved the desired efficiencies of the contestability model by becoming a low cost audit service provider but the robustness of its audit methodology and audit practices was considerably impaired.
- 5.8.10 However, the change to an allocation model where tendering of audits is the exception has provided an opportunity for the Auditor-General and Audit New Zealand to reinvest in training, methodology and quality control. This move to the allocation model has also allowed Audit New Zealand to recover fees for reasonable increases in the nature of its audit work and to improve its professional practices; create the aforementioned national training program for staff; update its audit methodology; and develop a new quality control system.
- 5.8.11 With respect to audit methodology, Audit New Zealand’s updated audit methodology puts more emphasis on fraud, documentation, risk assessment and controls. There are many standard forms and templates available to auditors to assist with the implementation of the new methodology. These forms and templates are reasonable and

consistent with the approach of many other National Audit Offices and private sector firms. Audit New Zealand has benchmarked the updated audit methodology against the Institute of Chartered Accountants in New Zealand auditing standards, the Auditor-General's auditing standards including the interpretative statements of the Institute's auditing standards as well as comparing it with that of some other national audit offices. Further updates to the audit methodology and templates are planned with respect to the integration of information technology specialists within the audit team and full compliance with International Standards on Auditing as they are adopted by the New Zealand Institute of Chartered Accountants and come into force (currently envisaged within the next three years).

5.8.12 The electronic working paper package of Audit New Zealand is TeamMate, which is also used by a significant number of other national audit offices. TeamMate, within Audit New Zealand, is governed by a TeamMate manual that prescribes strict naming conventions and specific guidelines for the creation of individual audit files. A review of the TeamMate practice manual and discussions with the manager responsible for TeamMate outline that Audit New Zealand is a leader in the use of TeamMate and indicate that good internal support is provided in respect of its use.

5.8.13 With respect to operational planning and reporting, Audit New Zealand demonstrates a clear relationship between strategic objectives in place, critical success factors, key performance measures, and outcomes. The accountability for each organisational outcome is clearly defined and the performance of Audit New Zealand against those measures is regularly monitored. An independent review of the efficiency and cost effectiveness at Audit New Zealand was also completed in July 2007. The review indicated that Audit New Zealand's core systems and practices are improving and noted, for example, that direct costs are reasonable when compared to those of comparable private audit service providers; that the dollar amount and the time spent on training is now reaching the same level as that of comparable private audit service providers; and, that the remuneration of staff falls within appropriate remuneration ranges, given the job characteristics and the market. The report, however, also identified several areas for improvement including:

- management information systems (including the timesheet and billing system) are not integrated and could be improved to provide better performance information;
- some staff grades, particularly for audit manager and audit director, where the productivity could be more comparable with that of private audit service providers;
- indirect costs at Audit New Zealand which represent 45 per cent of its overall costs could be closer to industry standards set at 30 per cent;
- knowledge management could be applied to a fuller extent; and
- opportunities for improvement exist to better manage workflow.

The OAG responded that Audit New Zealand has a range of business plan objectives in order to achieve these desired improvements.

5.8.14 In reaching its conclusions with respect to the operations of Audit New Zealand, the Peer Review Team noted that Audit New Zealand has reinstated a quality assurance system which, along with its audit methodology, permits it to comply with the standards of the Auditor-General, that is consistent with the Institute of Chartered Accountants of New Zealand's auditing standards and that is reflective of best practice. But this recent investment in training, methodology and information technology must remain strong and robust in order for Audit New Zealand to remain committed to maintaining a strong and

robust audit methodology; to maintain high professional standards; to maintain the level of skills and competencies required to pursue its audit operations; and to ensure consistent application of methodology, standards and procedures.

- 5.8.15 The Peer Review Team also acknowledges that Audit New Zealand has taken steps to improve its operational performance (eg. smoothing the workload, increasing the number of chargeable hours, and reassigning portfolios) but encourages further action to respond to the opportunities for improvement noted in the efficiency and cost effectiveness review of earlier this year.
- 5.8.16 The Peer Review Team itself examined the audit methodology, quality assurance process and operations of Audit New Zealand in more depth and identified a number of additional areas of possible improvement, as discussed below.

**Organizational Structure of Audit New Zealand and Co-ordination with the Office of the Controller and Auditor-General**

- 5.8.17 The organizational structure of Audit New Zealand would be best characterized as being flat and without any significant degree of internal specialization. Generally, each Director within the organization manages a portfolio of audit clients that can cover the total span of client types identified previously and reports directly to the Executive Director and/or the General Manager of the Operations group.
- 5.8.18 To assist audit staff, two functional specializations have been created in the areas of professional practices and specialist audit services. As well, there are five sectoral chairs who are responsible for providing advice and direction in respect of the five larger client groups of Audit New Zealand – local government, tertiary education, central government and crown entities, health, and licensing trusts/energy.
- 5.8.19 In the opinion of the Peer Review Team, however, the structure of audit operations in Audit New Zealand could be more efficient if audit responsibilities were assigned in a manner that would permit greater specialization amongst the Directors and staff. The result would most likely be greater economies of scale, greater efficiencies in the performance of the audit work and improved identification of audit issues. The OAG responded that Audit New Zealand has already moved to better specialisation in its recent re-allocation of Director Portfolios
- 5.8.20 The Peer Review Team also noted different levels of duplication between Audit New Zealand and the OAG. Firstly, as already discussed under sub-section 5.6 Annual Audit Performance of this report, the Accounting Technical group at Audit New Zealand performs work related to the application of accounting and auditing standards, while the Accounting and Auditing Policy group at the OAG covers the same ground. Secondly, Sector chairs at Audit New Zealand and Sector Managers at the OAG appear to have similar responsibilities as they are both responsible for providing direction to auditors in their area of specialization. Thirdly, reviews of controversial opinions can require an opinion of a review committee at Audit New Zealand and of yet another committee at the OAG. The results of one committee cannot impact on the need for, or answers of, the other. As a result, although it may be desirable to continue to treat Audit New Zealand as a quasi independent service provider, consideration should be given to reducing the level of duplication between Audit New Zealand and the OAG in order to improve the efficiency of audit operations.

- 5.8.21 Finally, the Peer Review Team noted that a number of the individuals working in the Professional Practices group of Audit New Zealand (including the General Manager) continue to have responsibilities for an audit portfolio. The rationale for this approach is that it provides these individuals with a greater appreciation of the responsibilities of the audit practitioners that they are attempting to assist and therefore more practical guidance and direction will be provided. With the increasing rate of change in international auditing standards and practices, however, it is now increasingly difficult for audit offices to ensure that their audit methodology and quality assurance services remain robust if their professional practices staff are not completely assigned to that task.
- 5.8.22 Consequently, Audit New Zealand should review the assignment of audit responsibilities to its professional practices staff to ensure that they can continue to devote sufficient time to keeping the audit methodology and practices of Audit New Zealand current and relevant. However, the OAG indicated that Audit New Zealand does not have the critical mass to fully assign its staff totally to the Professional Practices Group. Of the professional staff complement of eight, five staff members (including the General Manager) have an audit portfolio for audits for the year ended 30 June 2007. Moving forward, the audit portfolio for the General Manager has been considerably reduced: the Technical Director and Professional Development Manager no longer have an audit portfolio and the PPG is recruiting for a 0.5 FTE Audit Manager to assist the Director Audit Methodology and Director Audit Standards/ QA to ensure sufficient time is devoted to keeping the audit methodology and practices current and relevant. Audit New Zealand will continue to review the arrangement.

### **Quality Assurance Methodology and Practices of Audit New Zealand**

- 5.8.23 A new quality assurance system was recently reinstated and recorded in a Quality Control Manual. The material within the Quality Control Manual provides comprehensive direction with respect to, among other things, the following:
- leadership;
  - ethics and independence;
  - professional development;
  - engagement performance;
  - assignment of the engagement team;
  - differences of opinion within the engagement team; and
  - professional and technical consultation.
- 5.8.24 The Peer Review Team noted that, although the Quality Control Manual includes a wide range of policies and follows the recently implemented international standard on quality control, it does not provide sufficient information with respect to policies surrounding recruitment, performance evaluation, career development and promotion. During interviews, the Peer Review Team was made aware that such information exists but it is not part of the Quality Control Manual. The OAG agrees with the suggestion to ensure sufficient information surrounding recruitment, performance evaluation, career development and promotion is included in the Quality Control Manual. The policies relating to these subject matters are to be in the Human Resources Policies and Procedures. Audit New Zealand intends to update this into the next review of the Manual before 30 June 2008.

- 5.8.25 Another specific policy of the Quality Control Manual relates to when the Accounting Technical Group has developed a position on the matter in question or when there have been interpretations issued in respect of accounting or auditing standards, they will then provide training and updates to staff describing the result. These updates may be in the form of a newsletter to audit teams, updates to the technical guidance library that is available to all staff, or updates to audit manuals or electronic working paper tools. However, as discussed in paragraphs 4.4.19 through 4.4.22 of this report, during our interviews with staff of the Auditor-General and Audit New Zealand, we noted that knowledge management was highlighted as an issue within both organisations. In that regard, Audit New Zealand does have a number of tools and processes to disseminate key decisions and information but we did not find a comprehensive strategy addressing the organisation's approach to knowledge management including its approach to capturing and sharing the many decisions and positions that are established at an audit engagement level but that are not subject to changes in accounting standards or decisions by organisations such as the Auditor-General.
- 5.8.26 Moreover, when differences of opinion within the engagement team arise and are solved, the Quality Control Manual states that "If the team member is satisfied with the explanation, the original documented concerns should be deleted from the engagement file." In the opinion of the Peer Review Team, any notes signifying a difference of opinion within the team should be retained in order to evidence that the discussion arose and was resolved properly. The OAG responded that they did not agree and that their position was taken for professional risk management purposes.
- 5.8.27 Finally, the Quality Control Manual also indicates that Audit New Zealand will not include in its inspection work, matters that were undertaken for the OAG because that body does its own practice inspection. The checklists for inspectors confirm that no such work is undertaken (e.g. for performance audits and inquiries). Section 17 work, however, is subject to quality control and practice inspection. As a result, quality assurance inspections at Audit New Zealand should be extended to include all work done on the enhanced audit. The OAG responded that, it is their intention that because the OAG owns the product and Audit New Zealand only assists the OAG, the product should continue to be subject to the OAG quality assurance programme.

### **Annual Audit Methodology and Practices of Audit New Zealand**

- 5.8.28 Following the reinstatement of the Audit New Zealand quality assurance system in 2006, inspection results have highlighted several issues. Such issues are not of the significance that would have questioned previously issued opinions but do show lapses in application of audit methodology and practices. With the update of Audit New Zealand's audit methodology and policies with that of best practice and international standards, Audit New Zealand has identified a number of methodology application issues being addressed through the current and ongoing methodology work programmes and through National Professional Development training. This includes enhancing the quality of analytical reviews, the implementation of reliance and testing of information controls (a limited number of staff have electronic audit tools that permit testing of controls electronically or the extract and analysis of data directly from an information system) and improving the quality of planning and reporting of an audit.
- 5.8.29 The Peer Review Team itself also reviewed a number of audit files and saw evidence of the updated methodology and new quality control system as well as the areas for improvement noted in the quality assurance inspections. As a result, while it is noted that Audit New Zealand has the appropriate tools and methodology to conduct quality

audits and that staff are more focussed on their role, more effort is required to ensure that Audit New Zealand executes its new methodology and policies in a manner that will continue to deliver high quality professional services and adapt to the international changes in the accounting and auditing profession. In the opinion of the Peer Review Team, the response to these challenges should be for Audit New Zealand to continue its efforts to train all of its staff in the elements of the new audit methodology and practices but to also hold separate in-depth training on key elements of that methodology and separate training sessions customised and targeted for senior staff.

5.8.30 With respect to the structure of its electronic working paper package (TeamMate), the Peer Review Team noted that Audit New Zealand makes good use of TeamMate and would be considered a leader in its application but the Peer Review Team also noted that the structure of TeamMate does not make maximum use of software in the areas of planning and reporting. External paper files are kept of many of the planning and reporting documents rather than creating and keeping them within the TeamMate file – e.g. the planning memorandum. Seeking opportunities to increase the use of TeamMate in the planning and reporting phases of the audit may help with ensuring improved quality control over some matters identified in past quality assurance inspections. Audit New Zealand responded that, in their opinion, the way that they have structured their TeamMate file is fairly effective and efficient and their standard structure provides them with certain efficiencies including the tailoring of separate sector TeamMate libraries for planning purposes.

5.8.31 Finally, through a review of audit files, other unnecessary practices were observed by the Peer Review Team. For example, the Auditor-General requires a series of reports such as a copy of the Ministerial Letter and a report on the Audit Results even though such items are readily available within the TeamMate file. This material can easily be sent by way of a replica to the Auditor-General. In addition, the OAG does not seem to regard TeamMate as having use beyond the financial audit work of Audit New Zealand. Greater leverage is available in this area to enhance overall performance.

### **Human Resources Management and Other Related Issues**

5.8.32 Audit New Zealand maintains a record of staff attendance at internal courses (delivered by external and internal providers) but attendance at external courses is not monitored until the end of the year. A copy of the annual professional development declaration is maintained by the Professional Development group (which is a sub-group of the Professional Practices group) as an indication of Audit New Zealand's monitoring of professional practice requirements and external courses.

5.8.33 The Quality Control Manual also includes a policy related to auditor independence. However, more explanation is needed of the policy on auditor rotation, as opposed to the rotation of the quality control person, since it merely refers to a policy of the OAG and therefore makes it difficult for the reader of the Manual to fully understand the implications of this policy. The OAG responded that, in their opinion, the OAG's audit service provider manual policy contents on auditor rotation is sufficient for Audit New Zealand to refer to in its own policies.

### ***Suggestions for improvement***

- **The structure of audit operations in Audit New Zealand could be more efficient if audit responsibilities were assigned in a manner that would permit greater specialisation amongst the Directors and staff and reduce any duplication**

**between Audit New Zealand and the Office of the Auditor-General. The result would most likely be greater economies of scale, greater efficiencies in the performance of the audit work and improved identification of audit issues.**

- **Although the Audit New Zealand Quality Control Manual includes a wide range of policies and follows the recently implemented international standard on quality control, it does not provide sufficient information with respect to policies surrounding recruitment, performance evaluation, career development, promotion, and auditor rotation. During interviews, it was evident that such information exists but it is not part of the Quality Control Manual that can be easily accessed. This is a matter that requires attention.**
- **While it is noted that Audit New Zealand has appropriate audit tools and audit methodology to conduct quality audits and that staff are more focussed on their role, more effort is required to ensure that Audit New Zealand executes its new methodology and policies in a manner that will continue to deliver high quality professional services and adapt to the international changes in the accounting and auditing profession, In the opinion of the Peer Review Team, the response to these challenges should be for Audit New Zealand to continue its efforts to train all of its staff in the elements of the new audit methodology and practices but to also hold separate in-depth training on key elements of that methodology and separate training sessions customised and targeted for senior staff.**

## **5.9 Long Term Council Community Plans (LTCCPs)**

5.9.1 In New Zealand, the Auditor-General's mandate extends across the local government sector. The legal basis of New Zealand's core local government (entities known as regional, city or district councils) is provided by the following three statutes:

- Local Government Act 2002;
- The Local Electoral Act 2001; and
- The Local Government Rating Act 2002.

5.9.2 While the entities are created by Parliament, the elected members of local government are primarily accountable to the community which they represent and rate for the provision of services. Councils can undertake any function which promotes the well-being of their communities. Since 1996, Councils have been required to prepare long-term financial strategies. Under the Local Government Act, they are now required to prepare Long-Term Council Community Plans (LTCCPs).

5.9.3 The LTCCP is a 10 year plan and its purpose is to:

- describe the activities of the local authority;
- describe the community outcomes of the local authority's district or region;
- provide integrated decision-making and co-ordination of the use of the local authority's resources;
- provide a long-term focus for the decisions and activities of the local authority;
- provide a basis for the local authority to be accountable to the community; and

- provide an opportunity for the public to participate in decision-making processes on activities to be carried out by the local authority.<sup>3</sup>
- 5.9.4 Local authorities must follow a number of steps in preparing their LTCCP. These include:
- consultation with the community;
  - development of key policies and plans; and
  - putting in place financial strategies and performance measures.<sup>4</sup>
- 5.9.5 Two key documents in the LTCCP process are the LTCCP Statement of Proposal (including a draft LTCCP) and the final LTCCP. A summary Statement of Proposal is to be prepared to facilitate public consultation. The Act requires both the draft and final LTCCP to include a report from the Auditor-General. The Auditor-General is required to report on:
- the extent to which statutory requirements have been complied with;
  - the quality of information and assumptions underlying the forecast information provided; and
  - the extent to which the forecast information and proposed performance measures will provide an appropriate framework for the actual levels of service provision to be meaningfully addressed.
- 5.9.6 While the LTCCP has a 10 year planning horizon, all local authorities are required to prepare a plan every 3 years. The full provision of the foregoing requirements came into effect for the first time for LTCCP adopted for the period starting 1 July 2006. The next planning period will commence in July 2009, although plans requiring amendments during the intervening period also require a report from the Auditor-General. Discussions with stakeholders highlight that the OAG and local authorities are still working through issues and understandings in relation to the amendment process.
- 5.9.7 The introduction of these requirements produced some unique and challenging requirements for the Office, both technically and logistically. These included understanding and analysing planning systems; working with uncertain and possibly incomplete information and forward estimates; validating assumptions; and completing this for all authorities in the time prescribed. In addition, there was a desire to maximise the consistency in approach by the three Audit Service Providers to local authorities. Thus the OAG adopted the allocation model to allow Audit Service Providers to develop expertise in their field of LTCCP audits. Legal advice was obtained from time to time to assist in managing the risks that might arise from this activity and to consider the content of the proposed audit report.
- 5.9.8 The perception from a range of stakeholders was that this task was completed in a generally satisfactory manner but at some considerable cost to the major players, including the Office. It is understood that a significant proportion of the actual costs over initial estimates incurred by the Office have been absorbed by that office. It might be debatable whether a lower audit cost is sustainable into the future, even if, as expected, that it reflects the significant learning process undertaken in the first round of these audits. It was also evident to the Peer Review Team that the Office was heavily

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<sup>3</sup> Controller and Auditor-General 2007. *Matters arising from the LTCCP*. Page 11 (para 1.3)

<sup>4</sup> Ibid.



involved in the initiation and implementation of these developments in local government and remains so in planning for the next round of these audits.

5.9.9 As with all products of the Auditor-General, the LTCCP audits have been subject to a recent quality assurance review which, perhaps not surprisingly for a new product, has identified a number of procedures and practices requiring attention and review not only for the next round of audits but also for audits of LTCCP amendments as they come to hand. The review also identified a number of procedural strengths from the current round on which to build going forward.

5.9.10 OAG responded to the above observations as follows:

Throughout 2007, the Office has been working with the sector on the implementation issues (and ongoing issues) by bringing the matters to relevant stakeholders (and primarily through SOLGM). Our clear strategy/message is that these are generally matters for the sector to consider and deal with. The sector (and again particularly SOLGM supported by LGNZ and NAMS) had commenced, by the time of the review, a substantial programme to better define good practice. This work has been undertaken by the sector for the sector. We have clearly been on the sidelines and provided comment where appropriate, but the initiatives remain that of the sector. We have been mitigating the risk that we implement and then audit. As an office we have been undertaking a complete overhaul of the LTCCP methodology. This has been very much based around the quality assurance review undertaking as well as with direct feedback from the audit teams. The revised methodology –with the A&AP support – will go live in 2008.

#### *Suggestions for Improvement*

- **It is incumbent on the Office of the Auditor-General to ensure it remains sufficiently independent of implementation issues related to local government to retain its objectivity and cautious scepticism as part of its audit responsibilities and also be seen to be doing so.**
- **The Office of the Auditor-General is strongly encouraged to address comprehensively the full range of issues emerging from the recent quality assurance review covering the LTCCP.**

## **5.10 The Controller Function**

5.10.1 The Controller Function has its origins centuries ago in the United Kingdom and has existed in New Zealand since 1865. The function was designed to provide for the safe keeping of public money and to ensure it was only spent in accordance with the appropriation decisions of Parliament. Money could be spent only after it had been issued under the authority of Parliament. Until recently, the Controller's primary function has been to certify, before the event, that all payments of public moneys from the Crown bank account into a departmental bank account are in accordance with a warrant issued by the Governor-General and that there is an appropriation or other statutory authority against which payment can be charged. As the select committee noted during the 2004 reforms, this system had become effectively symbolic with a warrant being issued daily. The substantive work was in fact taking place through the check on appropriations during departmental audits.

5.10.2 The Controller Function was modernised and changed, effective July 2005, to meet the requirements of a full accrual accounting environment, including accrual-based appropriations. In such an environment, the key point of control should be at the time expenditure is incurred, not when it is actually disbursed. Key features of the new environment include the following:

- Treasury is required to supply monthly reports to the Controller to enable the Controller to examine whether expenses and capital expenditure have been incurred in accordance with an appropriation or other authority;
- the Controller can direct a Minister to report to Parliament if the Controller has reason to believe that any expenditure has been incurred that is unlawful or not within scope, amount or period of any appropriation or other authority; and
- the Controller can stop payments from a Crown or departmental bank account.

5.10.3 Departments provide information to Treasury to enable it to compile and provide the monthly report to the Controller and Auditor-General.

5.10.4 Closely related to the Controller Function is the appropriation audit. Consequently, the two roles have been described as inextricably intertwined. In accordance with the Auditor-General's Auditing Standard number AG-2, the appropriation audit has been carried out, by Appointed Auditors, as an integral element of the departmental annual financial audit. As part of the modernisation process mentioned above, the Public Audit Act 2001 was amended to ensure that the appropriation audit is carried out as a matter of statutory duty rather than at the discretion of the Auditor-General. As a consequence, Appointed Auditors are required to audit all appropriations to:

- determine whether expenses or capital expenditure have been incurred within the amount, scope and period of an appropriation or other statutory authority;
- ensure that expenses incurred have been for lawful purposes; and
- ensure that any unappropriated expenditure is reported in the financial statements of the relevant department.

While the appropriation audit is separately provided for under legislation, it is the practical basis for the exercise of the powers associated with the Controller function.

5.10.5 To give effect to this modernisation process, the Auditor-General and Treasury have established a Memorandum of Understanding (MOU) to outline their joint understandings and expectations of the role and procedures associated with the Controller function.<sup>5</sup> The Auditor-General has reviewed and reissued the relevant Appropriation Auditing Standard. Each month the OAG operates the Controller function under certain standard procedures in accordance with the auditing standard and the MOU

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<sup>5</sup> The MOU can be accessed on the Treasury website <http://www.treasury.govt.nz/controller/default.asp>

- 5.10.6 Following the completion of the first financial year of operation of the new procedures, the OAG initiated a quality assurance review of the process underlying the appropriation audit and Controller Function which identified a number of issues for consideration going forward. The review highlighted that the monthly monitoring undertaken as part of the Controller Function is reliant on the satisfactory operation of the following controls and safeguards and, as such, is only as effective as the following:
- the information provided by departments (and subsequently Treasury) is subject to the departments' own internal control processes;
  - departments are subject to an annual department internal control evaluation; and
  - departments are subject to annual audits and their financial statements must reconcile to the financial information provided to Treasury to facilitate the preparation of Whole of Government Consolidated Financial Statements.
- 5.10.7 The quality assurance review also notes the monthly monitoring is unlikely to identify breaches that have not already been identified by departments (or Treasury). The OAG has advised that there is greater discipline in the system now because there is regular reporting and monitoring of expenditure against appropriation. The fact that there is an independent Controller with powers to act (if and when required) and who also carries out an independent appropriation audit alongside the monthly reporting process provides a strong incentive for departments to 'self declare'. This is evidenced by the number of breaches identified in the first year of operation of the monthly reporting process (84 instances in 2005/06, compared with 45 in the two previous financial years). The number of breaches in 2006/07 was 46, which would indicate that system improvements have been made to address issues that came to light in the first year. As previously noted, the successful completion of the appropriation audit is essential for effective operation of the Controller function. This work is generally not completed until late in the financial year and thus the nature of, and timing for, the effective execution of the Controller function has moved under the modernisation process, from a preventative model to a detective model.
- 5.10.8 The quality assurance review identified a number of key findings with the execution of the appropriation audit which imposes risks to the successful execution of the Controller function and would also impact the integrity of the annual financial audit. The review found that there was inadequate documentation within many of the files reviewed to demonstrate compliance with key aspects of the relevant auditing standard. In addition, the level of compliance with key aspects of the standard varied between the various Audit Service Providers. The Controller function monthly work was found to be consistent with the MOU. The OAG has advised action has been initiated to address the recommendations of the quality assurance review.
- 5.10.9 The Peer Review Team notes that, in a number of other jurisdictions, responsibility for the "Controller" function has been effectively subsumed within the executive arm of government, with the relevant Auditors-General considering departmental compliance with appropriation legislation in the context of their annual financial statement audits. Parliament carefully examined this function in 2004 and took steps to strengthen it, as described previously, rather than remove it. The Peer Review Team also notes the Controller and Auditor-General's strong view that he continues to have an effective role to play in this process, given the particular New Zealand governance arrangements.

## **6. Performance Auditing, Good Practice Guides and Inquiries** *(Sections 16 and 18 of the Public Audit Act 2001)*

### **6.1 Introduction**

6.1.1 In this Section, we review the discretionary work of the Auditor-General; in particular, the performance audits and inquiries, which make up around 10 per cent of the Office's activities but which are quite pervasive in their impact. There are also important discretionary activities associated with the financial statements and assurance activities, as covered in sub-section 5.3.

### **6.2 Performance Auditing**

6.2.1 The Auditor-General has the authority to undertake performance audits under Section 16 of the Public Audit Act 2001. Such audits are a key element in the delivery of the Auditor-General's five responsibilities under the Act; in particular to ensure that resources are obtained and applied in an economical manner (i.e. that taxpayers' dollars are not wasted).

6.2.2 Performance audits cover both central and local government spending. Following a significant increase in funding in 2004, the number of performance audit reports published by the OAG rose steadily from 10 in 2004-05 to 15 in 2006-07. Between 19 and 21 reports (including special studies and inquiries) are planned for 2007-08 of which 14 will be performance audits. On average, performance audits take between 9 and 12 months to complete; and most studies cost between \$170,000 and \$230,000, with the total estimated cost for the Performance Audit Group (PAG) for 2007-08 being around \$2.4 million.

6.2.3 As well as performance audits, the PAG also provides wider assistance to the Office. For example, the Group supports inquiry work and has produced or contributed to the expanding range of good practice guidance published by the OAG in recent years, such as that on managing conflicts of interest for public entities.

6.2.4 Overall, we found a robust performance audit framework, with thorough processes and quality assurance arrangements complementing the findings of other external quality assurance reviews in recent years.

6.2.5 The reports themselves were clearly written and easy to follow. We must also acknowledge the positive comments made about the OAG's performance reports in our interviews with Ministers, Select Committees and public entities. These were in keeping with the results of the OAG-commissioned 2007 Stakeholder Feedback Interviews with Select Committee Chairpersons and Deputy Chairpersons and other stakeholders from Treasury and the New Zealand Society of Local Government Managers which showed all respondents as satisfied with the quality of OAG performance audits and 86 per cent satisfied with their usefulness. The report also made reference to the general comment from Select Committee Chairpersons and Deputy Chairpersons that the feedback they receive from their Members is very positive about the Office.

6.2.6 We recognise that a large body of material has been generated in recent years appraising the functioning and outputs of the PAG. We are also aware of current initiatives by the OAG to sharpen the focus of the planning cycle and to improve the efficiency and speed of delivery of audit reports, in particular the Performance Audit Process Improvement Project.

6.2.7 Beyond the interviews with a wide range of stakeholders, we reviewed a wide range of documents, including procedural and process guidance, and all recent internal and external quality assurance reviews. We also examined a sample of six performance audits published in the later months of 2006-07<sup>6</sup>, together with the related Post-Project Reviews, which represent an important quality assurance mechanism in their own right, providing a useful analysis of each audit assessed against a set of common criteria.

### **Audit Strategy**

- 6.2.8 The overarching elements of the Auditor-General's Strategy for performance audits are set out in the Office's 2004-09 Strategic Plan. These include increasing the number of performance audits, expanding the suite of good practice guides, and improving the timeliness of performance audits by introducing project management disciplines.
- 6.2.9 The Auditor-General's Annual Plan for 2007-08 identifies four "core areas of interest" to the Auditor-General in the selection of performance audit topics:
- public investment or liability management;
  - public revenue management or generation;
  - asset management or infrastructure spending or management; and
  - expenditure, including service delivery expenditure.
- 6.2.10 The Auditor-General has defined his role in the Annual Plan as being "*to regularly provide assurance about the activities of public entities that are large and complex, and/or where it is difficult to assess their performance*".
- 6.2.11 Generally, the performance audits listed in the Annual Plan are completed in the year to which the plan relates. Inevitably, some are delayed or displaced by new or more pressing topics. Out of the 20 performance audit reports and other studies published in 2006-07, five were additions to the original work programme. Also in that period, four topics were either deferred or were presented to Parliament in a different form, while two others were deleted from the work programme and one, on e-government, was not continued with. The range of topics reported upon meant that there was good coverage of public expenditure, although, with the deferment of the major acquisition projects report to 2007-08, there were no audits completed in the Defence area in 2006-07. Here we are conscious of the comments made in stakeholder feedback interviews by the Chairperson and Deputy Chairperson of the Foreign Affairs, Defence and Trade Committee; in particular their wish to see year-on-year financial and performance trend information in reports, including a deeper insight into the capital flows that exist within departments.

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<sup>6</sup> The six performance audit reports in question were:

- Ministry of Social Development: Performance of the Contact Centre for Work and Income, December 2006.
- NZ Qualifications Authority: Monitoring the Quality of Polytechnic Education, May 2007.
- Ministry of Health and District Health Boards: Effectiveness of the 'Get Checked' diabetes programme, June 2007
- Assessing Arrangements for Jointly Maintaining State Highways and Local Roads, June 2007.
- New Zealand Customs Service: Collecting Customs Revenue, June 2007
- Department of Labour: Management of Immigration Identity Fraud, June 2007

(We also looked at a seventh performance audit report – that on the New Zealand Debt Management Office. This was an audit undertaken by a contractor and we were interested to see whether there were any wider learning points from the experience of a contracted-out performance audit.)

- 6.2.12 Most audits in 2006-07 were about either service delivery or operational performance. There were no studies looking directly at capital spending, although there are a number planned for 2007-08, such as that on local government asset management planning.
- 6.2.13 The Auditor-General is considering whether the current balance of studies is appropriate. For example, whether there would be value in publishing one or two larger and more wide-ranging reports going beyond the more traditional examination of discrete programmes within an entity, to look at the performance of that entity more generally or to look across a sector or sectors. This would be in keeping with wider developments in New Zealand public administration focused at more “joining up” of public service delivery around the needs of citizens and customers.
- 6.2.14 There is recognition at senior levels within the OAG that there is considerable scope to streamline the performance audit function. For example, a study in early 2007 identified a total of 69 steps involved in the conduct of a typical performance audit. In an effort to simplify these arrangements, without sacrificing quality, there is in place an initiative – the Performance Audit Process Improvement Project – which aims to reduce this number to around 24 steps. This, it is hoped, will also shorten the timescale for the completion of performance audits by around 12 to 17 weeks (the average length of a performance audit is currently around 42 weeks, plus around 4-6 weeks of fieldwork); reduce the bunching of publications around the financial year end; and make for more timely reports generally. Beyond these intrinsic benefits, it was put to us by staff in entities that, while a performance audit is on-going, there may be reluctance on the part of an entity to move forward with a reform or initiative, preferring to await the outcome of the OAG’s performance audit work. This may, in turn, risk delays to performance improvement.

### **Compliance with Auditing Standards**

- 6.2.15 The OAG Performance Audit Manual is the standard reference for the conduct of performance audits. A review of the processes underpinning the performance auditing function (by reference primarily to the Manual), conducted by the OAG’s Accounting and Auditing Policy QA team in March 2007, concluded that appropriate systems and controls were in place to “mitigate exposure to identified potential risk and protect the Office’s role in conducting performance audits”. The review did, however, record that there was, at times, a lack of documentation to determine whether the controls had in fact operated.
- 6.2.16 It is OAG policy that performance audits should, wherever possible, conform to the Auditor-General’s Auditing Standards which are, in turn, aligned with the New Zealand Institute of Chartered Accountants’ Standards. In 2006, at the request of the Auditor-General, a review was conducted by the PAG to assess the degree of compliance with those Auditing Standards. The review found that the Group generally complied with the Standards but that improvements could be made to document this more clearly and consistently, setting out the changes to the Manual designed to bring this about. It concluded that “*where performance audits are conducted in accordance with the Manual then compliance with the Auditing Standards occurs without additional effort.*”
- 6.2.17 Following the PAG review, an amendment (dated 1 September 2007) was made to OAG procedures whereby the Assistant Auditor-General, PAG, is now required to sign-off each audit certifying that “*I have reviewed the necessary documents and records, and have conducted the relevant inquiries, to be assured that this draft report and supporting work are consistent with the Auditor-General’s Auditing Standards.*”

- 6.2.18 In 2008, as a further test of compliance, the OAG's Accounting and Auditing Policy QA team will be looking at how Auditing Standards are applied in performance audits.

### **Audit Selection**

- 6.2.19 Against the overarching criteria for topic selection set out in the Annual Plan, there is a well-established "Strategic Audit Planning" process for identifying and refining topics for examination. This starts with initial "environmental scanning" by the OAG's leadership team, usually in February. It is followed by various stages of study development and refinement before a draft work programme is sent for comment to Parliament and to overarching bodies, such as the State Services Commission for central government, and the New Zealand Society of Local Government Managers for local government, around December each year. A further formal but short round of consultations on the statutory draft Annual Plan, taking in earlier views and comments, is undertaken in the period between the end of March and mid-May when the Auditor-General's Annual Plan and budget are tabled.
- 6.2.20 Our consultations with Ministers, MPs and Select Committees showed a good general level of satisfaction with the consultation process, with a feeling that it did allow Members the opportunity to raise issues and concerns. The point was made, however, that this is essentially a passive process, undertaken through correspondence. It was put to us during our discussions with the OPC that there might be scope for a drawing together of comments and suggestions from the initial round of consultation as the basis for a discussion between the Committee and the OAG, before the Office finalises its performance audit programme. This would be a natural complement to the recommendation in the 2006 Governance Review that *"a high level and non-attributed summary of the content of feedback from Parliament and stakeholders on the proposed scope and priorities in the Auditor-General's discretionary work programme, and of the Auditor-General's reasoning and conclusions on that feedback, should be disclosed with the Annual Plan or other documents containing the decisions on the work plan."* Comment on specific proposals for performance audits or studies that did not make it through to the final programme would also be useful.
- 6.2.21 The occasional comment was also made that some of the OAG's performance audit reports addressed relatively minor issues (although these views were directed more at inquiries than performance audits). There was also a view that there was scope for performance audits to take a wider look at systemic issues and effectiveness - an issue also of interest to the Auditor-General.
- 6.2.22 It is current practice for the OAG to hold discussions with senior managers (usually Chief Executive Officers) about the intended performance audit work programme to seek their input, as well as providing feedback about the final decisions reached. Senior staff in public entities interviewed for this review were generally supportive of the OAG's performance audit work; although they felt that on occasion there might be more important topics for the OAG to pursue. They also wanted to be kept informed about the emerging scope and design of specific audits. In the light of the evidence from this review, the OAG might wish to canvass the views of heads of agencies to determine how the consultation process with their organisations might best meet the objectives of all concerned. While ultimately it is, of course, for the Auditor-General to determine the programme of performance audits, senior stakeholders in public entities are well placed to understand where performance audits can have most impact in bringing about improvement. For this reason, it is also useful to keep under review any need to consult

such stakeholders directly during the audit, rather than simply to rely on any liaison arrangements put in place at the outset.

- 6.2.23 Since 2006, effort has been focussed on securing a greater involvement of performance audit teams in study selection and design. While Sector Managers remain responsible for the initial selection work, both PAG and Sector Managers (a roughly 80/20 per cent division of responsibility) now carry out detailed scoping earlier in the planning cycle to develop and test a shortlist of around 25 audit proposals. This involves performance audit teams meeting with the relevant Sector Manager, the appointed auditor, and the auditee “*to identify any potential issues that may be an impediment to...undertaking a performance audit*”. A Preliminary Scoping Template is then completed.
- 6.2.24 In some instances, the scoping process has been protracted due to differing expectations of the performance auditors, Sector Managers, the auditee and OAG senior management about the focus of the audits. As part of the move towards closer joint working there have also been successful experiments with “issue analysis” meetings, where Sector Managers, performance auditors and representatives from the auditee have come together to discuss a study proposal and to achieve some consensus of views.
- 6.2.25 The issue of the scope of performance audits has been raised in external reviews as well as by the PAG themselves following a March 2007 exercise examining the Post Project Reviews for 19 performance audits completed in 2005 and 2006:
- “Insufficient scoping being undertaken to understand the sector, and in particular, to establish whether the audit was relevant and well timed or might conflict with other reviews or activities in the sector.”*
- 6.2.26 More positively, one Post Project Review also identified a case where in-depth research and scoping work had paid off, creating a “*well focused clear and useful audit*”.
- 6.2.27 On some occasions, issues with project timing have resulted from the scoping process not identifying imminent developments in the audited bodies. For example, a proposed study on tertiary education was deferred from 2004 to 2006 when it was discovered that the New Zealand Qualifications Authority was performing its own review that overlapped with the areas that the PAG were expected to cover. During a performance audit of health information, the Ministry introduced a new information strategy which would have been arguably the better focus for the audit.
- 6.2.28 One potential measure of the correctness of the selection and scoping process of performance audits is the number of audits that are either not started or, ultimately, have to be abandoned. In 2006-07, two topics were deleted from the work programme, while only one (on e-government) was not continued with, as noted earlier.



### *Suggestions for Improvement*

- **The Office of the Auditor-General should consult with the Officers of Parliament Committee and the Finance and Expenditure Committee to determine the value they would see in a more proactive discussion on the Office’s draft performance audit work programme. This would include commenting on the reasons for specific proposals for performance audits or studies not being included in the final programme.**
- **The Office of the Auditor-General may wish to discuss with heads of major public entities how the existing consultation arrangements on the Office’s performance audit work programme might be further developed and refined; and, where a performance audit is pursued, whether there would be merit in more direct contact with the relevant Chief Executive during the key design and scoping stages of the audit.**
- **The Office of the Auditor-General should undertake an analysis of Post Project Reviews covering performance audit reports published in 2007-08 to determine how the closer involvement of performance audit teams with the scoping of performance audits has paid dividends. The Office of the Auditor-General should also continue to explore new and innovative ways to get to the bottom of topics, such as making further use of “issue analysis” meetings, to make sure that it has full knowledge of entities’ plans and vice-versa.**

### **Audit Methodology**

- 6.2.29 There are some very positive aspects of the methodology used in the performance audit work of the OAG. Many of the reports make effective use of examples to illustrate good practice and to draw lessons for future delivery. For example, the report on the effectiveness of the ‘Get Checked’ diabetes programme contained good examples of successful local initiatives that could be replicated. Similarly, the roads report contained a useful chapter on good practices in collaboration between local and central government under the title: “*What makes collaboration successful*”. The reports also reflect the views of service users as well as the auditees, giving the reader a sense of whether or not government services are held in high regard by the people who use them.
- 6.2.30 Against a backdrop of informative and well-received reports, we offer below some thoughts about possible areas for future development of performance audit methodology, drawing on comments made by other recent external reviewers and examples from the reports we have examined in order to help illustrate the better practice that might be considered. We should also record that the reports examined were prepared under the very arrangements that are currently the subject of OAG scrutiny and reform, and we hope that our observations will assist the OAG in shaping its new approach.
- 6.2.31 The OAG’s performance reports generally aim to provide assurance about specific issues or programmes and their management by the relevant public entity or entities. They usually focus on what might be termed “assessing performance against expectations”; by testing compliance with pre-determined targets or criteria. Where these are based predominantly on the entity’s own objectives and standards, there is a risk that, without some form of external benchmarking, the audit report may hold entities to modest or undemanding measures that do not encourage the *stretching* of

performance. Here we were struck by the recent comment of an external quality assurance reviewer *“It is important not to trivialise performance auditing by making it a mere compliance report against unilaterally developed management standards.”*

- 6.2.32 We raise this issue as a potential generic risk to the overall quality of performance audits. We are conscious, however, of recent examples where audits have used successfully external benchmarking, such as that done in the Contact Centre report to appraise auditee performance against industry good practice.
- 6.2.33 When commenting on particular activities, OAG performance reports are limited, at times, to a description of analyses or evaluations that the entities themselves have done, or to recording, for example, what the *“council told us”* or what the entity *“believes to be the case”* without offering a conclusion on whether or not the activity is well performed and cost effective. This leaves the reader with potentially unanswered questions, as the following extracts from reports indicate:
- “Service Express has the potential to reduce the number of calls that need to be answered by Customer Service Representatives. Fewer calls could lead to savings for the contact centre and shorter waiting times for callers.” (Contact Centre report, paragraph 2.86);*
- “The Service has not compared its methods with alternatives. Therefore we were unable to form a view about whether it is the most effective and efficient method.” (Customs report, paragraph 2.57); and*
- “Transit had not formally compared the costs and benefits of collaborative agreements with other network management approaches.” (Roads report, Summary, page 7).*
- 6.2.34 At times, the data simply does not exist within the entity, or elsewhere, to allow the OAG to undertake the necessary analysis, and it would be too resource expensive for the OAG to generate it independently. For example, the complexity of the different arrangements on the roads report would have made it very difficult for the audit team to have reached an independent and definitive conclusion on the costs and benefits of the various schemes. As it turned out, the report was only able to describe the financial computations done by the constituent local authorities and Transit.
- 6.2.35 An entity’s lack of information is itself a potential audit finding. Consequently, the OAG may want to consider being more ready to offer an opinion on whether or not it considers that the entity should have had the particular information available for analysis and decision-making.
- 6.2.36 The OAG makes use of a range of methodologies in its performance audits including interviews and document examination and checks upon processes and procedures. As well, it undertakes surveys and performs statistical analyses to provide new, independent insights into an auditee’s activities and performance. For example, the Roads audit involved the collection and analysis of road condition data. From our review of recently published reports, and comments from external reviewers, there is potential for the OAG to have more of this independent research and analysis in its reports, and rather less descriptive content.
- 6.2.37 The foregoing outcome might be achieved through the greater use of surveys, more external benchmarking of performance, as happened in the Contact Centre audit, or

through the commissioning of statistical research or modelling to determine the key contributors to successful performance and/or to examine performance variations.

- 6.2.38 It may also be useful to have a rather more formal demonstration of the reasoning behind the methodologies used in a given report; by setting out in a separate appendix the rationale for the methods used, and details of each; why, for example, a particular sample size was chosen, the number of interviews undertaken, who was interviewed and at what level, and the purpose for doing so. This relatively straightforward measure would provide a discipline on the audit team to demonstrate and justify their choice of methodology and, in our opinion, give performance audit reports added authority and conviction.
- 6.2.39 We note that, at times, there is only limited financial analysis in performance reports. More quantification of the costs and benefits of government programmes would help to determine whether entities are choosing the most cost-effective means of achieving their objectives. For example, this might have worked well for the Contact Centre report exploring the relationship between staff costs and service levels, and within this, the financial impact of “Service Express”. Similarly, in the Diabetes report, various stakeholder views were recorded on the adequacy of the \$40 fee paid to GPs for each patient check carried out. It might have been useful for the PAG, without questioning the policy, to commission further research into this issue to better understand, for example, the influence that the fee had on GPs to encourage patients to participate in the “Get Checked” programme compared with other factors.

### *Suggestions for Improvement*

- **Where an entity’s performance is assessed against internally set standards, there is a risk that performance audit reports may not encourage the stretching of performance. At the audit planning stage, the PAG should test to see whether the methodologies proposed for the audit will yield sufficient independent benchmarking, research and analysis to provide an objective assessment of the auditee’s activities and performance, including whether the immediate targets and standards that the audited body has set for itself are sufficiently challenging.**
- **The Office of the Auditor-General may wish to be more ready to offer an opinion on whether it considers that, where particular information is unavailable, the entity should have had that information available for analysis and decision-making.**
- **More financial analysis would be helpful in some reports, particularly those that examine particular programmes and initiatives.**
- **More quantification of the costs and benefits of government programmes would help determine whether entities are choosing the most cost-effective means of achieving their objectives.**

### **Presentation in Reports**

- 6.2.40 Overall, we found performance audit reports clear and easy to read. There were examples of particularly useful report structures, such as chapters three to five of the Immigration report which detailed clearly at the front of each section: what that section

would cover; what the OAG expected to see; and how the department had performed against these expectations.

- 6.2.41 The structure of some reports meant that the reader did not always get immediately to the most important findings because there was rather too much descriptive material in the way. The Immigration report contained very incisive points on staff training and backlogs, but these were only covered in detail towards the end of the report. By contrast, the Contact Centre report highlighted its key findings in Part 2 of the document, but this meant that there were very few recommendations stemming from the remainder of the report. That report might have given more prominence to the useful and practical steps to strengthen the performance of the contact centre rather than just having them included in an Appendix.
- 6.2.42 Our reviews of performance audit reports raised questions at times about why particular issues had not been covered, suggesting that there could be more discussion in the text on what exactly the report was focussing on. For example, there is important commentary in Part 4 of the Customs report about the information currently available on levels and trends in compliance (that is, whether all the customs revenue due is actually collected). The scope of the audit at the front of the report, however, makes reference only to revenue collection arrangements and does not mention compliance issues, leaving the reader potentially unsure about the issues that the report will address. In fact, the answer in this case was shown in the Post Project Review as follows:

*“We discussed Customs’ comment that they would have liked the audit to have included an assessment of Customs’ capability to collect revenue. We agreed that this is a good topic, but would be an audit of its own.”*

- 6.2.43 The view of OAG and entity staff was that, to have comprehensively covered both collection and compliance in this particular performance audit would have made the audit unmanageably large. It might have been helpful, for reasons of clarity, to have included such an explanation in the report itself.
- 6.2.44 More summary financial detail in reports would be welcome. For example, while the Roads report did not reach an independent and definitive conclusion on the costs and benefits of the various schemes under review, some simple high level figures in the summary, such as the total cost of state and local road maintenance, would have been helpful.
- 6.2.45 While, in the main, the recommendations made in performance audit reports are clear and well targeted, it was also put to us that some are more about fine-tuning, or tend to confirm actions already planned or put in train by the entity in question. In addition, previous external reviewers, and this present review, have found some recommendations to be rather generalised in nature. While the purposes of the performance audit reports are different to those of Peer Reviews, we were conscious of this issue in making our suggestions for improvement. We were also conscious of the results of the PAG’s own March 2007 review of Post Project Reviews, which reported (in the context of follow-up audits) that some *“original recommendations had not been framed in a way to allow easy auditing and had to be re-formulated for the follow up.”*
- 6.2.46 Steps to sharpen recommendations include a recent amendment to PAG procedures to emphasise that recommendations should be *significant* and *targeted*. To these might be added the good practice of being *measurable*: setting out wherever possible clear timescales for action by the entity, and by defining the criteria against which the impact

of a recommendation should be assessed. To assist this approach, audit teams would benefit from practical examples of what significant, targeted and measurable recommendations would look like under a range of different circumstances. Perhaps too, there are lessons to be learned from those teams planning follow-up reports; and that, in principle, good recommendations should be capable of “easy auditing” at some future date.

6.2.47 Making sound and helpful recommendations can be problematic and, at the time of writing, UK National Audit Office, for example, was itself giving considerable thought to how the recommendations in its own value for money reports could be improved. The following are five criteria drawn from the views of the UK National Audit Office staff for what makes for a good recommendation. They should be:

- logically linked to the findings of a study;
- costed and time-related;
- specific in the proposed action and clear in the outcome or benefits;
- based on sound evidence; and
- carefully targeted at the appropriate person/people.

6.2.48 The reports might also benefit from more frequent use of graphical presentations. Where graphics are used at present, they mainly set out management structures or information flows, whereas they could be an effective way of both summarising performance and financial information in the introductory sections of reports and describing the results of analyses. For example, the Immigration report might have benefitted from a simple graphic early in the report to illustrate how many people apply and are accepted/rejected under the different immigration streams covered in the report. Figures in the Contact Centre report demonstrated very well how graphics can contribute to analysis and reader understanding of the issues in the report.

#### *Suggestions for Improvement*

- **The structure and content of reports could be altered to reduce descriptive content and give more prominence to key findings and analysis in direct support of recommendations.**
- **Reports could include more explicit explanation of their scope.**
- **In addition to recent new instructions to performance audit teams that recommendations should be significant and targeted, we would add that they should also be *measurable*: setting out wherever possible clear timescales for action by the entity, and by defining the criteria against which the impact of a recommendation should be assessed.**

#### **Capacity and Capability**

6.2.49 The PAG has around 15 audit staff reporting to a Manager and an Assistant Auditor-General. Typically performance audits are carried out by a small team of OAG staff (1-3 personnel) drawing in expertise from other areas as necessary, including staff from Audit New Zealand and, within that, from the Special Assurance Services. Where more specialised expertise is required, the OAG will commonly draw upon the advice of outside experts. For example, the “Get Checked” study on diabetes drew upon the advice of an eminent university professor in that field of medicine.

- 6.2.50 The question of matching skills and experience to performance audits has been raised by various parties. The March 2007 review of performance auditing processes by the OAG's Accounting and Auditing Policy QA team recommended that the PAG demonstrate more clearly at the outset that teams have the necessary skills and competence to perform the audit and identify what specialist advice or expertise should be sought. In response, in April 2007, a new template form was introduced to provide an explicit focus on staffing issues as part of the detailed audit planning.
- 6.2.51 More generally, in our discussions with entities, there was a perception that the OAG had faced some challenge in developing its capacity to match the significant increase in resources availability in 2004 and the related increase in the number of performance reports produced annually. As with other parts of the OAG, the capacity to recruit and retain staff also remains a challenge, as we have noted elsewhere in this report. Our review of Post Project Reviews showed that core teams on performance audits are often small, leaving audits potentially vulnerable to a loss of continuity should a staff member leave the team, and limiting the methodological depth that can be achieved. The OAG might consider reviewing staff levels for performance audits, looking at issues of capacity and continuity.
- 6.2.52 Where particular skills are not available in-house, the OAG may need to buy these in from contractors. Beyond the conventional range of studies, the OAG has in the last few years tackled more technical subjects, most recently the New Zealand Debt Management Office. In recognition of the specialist nature of the issues at hand, this study was contracted out to KPMG. This required a different set of skills around the management of a contractor and, in keeping with good practice, the lessons learned from this exercise have been captured in the form of a detailed internal memorandum on the subject (*Contracting out a performance audit: lessons and materials: January 2007*).
- 6.2.53 Alongside immediate staffing issues there is also a question about whether the balance is right between the resources invested in the design and conduct of a performance audit and the amount of effort put into its oversight and review. As identified earlier, a performance audit team is typically small (1 to 3 personnel); yet there can be many times that number of personnel involved in reviewing the same report. In our own research, it was put to us that a performance report can be exposed to as many as 20 people during the various review stages.
- 6.2.54 For each performance audit there is a Project Steering Committee, the purpose of which is to ensure that governance and risk management issues are addressed effectively. To achieve this, each Committee consists of a wide range of OAG individuals including senior members of the PAG and other senior staff from within the OAG. The March 2007 review by the Accounting and Auditing Policy QA team found difficulty, however, in assessing how the composition of Committees had been determined and why the members selected were considered to be the "best people" for the particular performance audit.
- 6.2.55 Our examination of Post Project Reviews identified some positive comments about the value of the contributions made by individuals on Project Steering Committees. More generally, however, there was a view amongst OAG staff that these Committees can constitute an over-engineered and time-consuming process (with elaborate planning necessary to allow large numbers of staff to come together, rather than to necessarily meet the timing needs of the audit). External reviewers have also commented that the very numbers involved the risk of a dilution of responsibility, encouraging a sense that no one in particular is accountable. This raises questions about whether the resources

involved are being used as effectively as they could be in producing the required outcomes.

- 6.2.56 Work continues on reforming this process, in particular to potentially replace the sometimes large and unwieldy Project Steering Committees with a much smaller, sharply focussed, governance team of three senior OAG staff but it is not yet entirely clear what role this team will play between high level governance and being involved in the more day-to-day management of the study. The OAG is piloting this new model on three audits as part of wider improvements from the Performance Audit Process Improvement Project, before deciding what changes can be made to make project management and project governance more efficient.

#### *Suggestions for Improvement*

- **With 14 performance audits to deliver in 2007-08 and a core audit staff of around 15, the Office of the Auditor-General might consider reviewing staffing levels for performance audits, looking in particular at continuity and at its capacity to do justice to the range and number of audits tackled each year.**
- **The Office of the Auditor-General should investigate whether a better balance can be struck between the effort and resources committed to the conduct of a performance audit and that committed to its review.**

#### **Quality Assurance**

- 6.2.57 The OAG uses a range of internal management arrangements to oversee the quality of audit reports and to monitor performance against time and budget constraints, including:
- a *Project Steering Committee* which meets every 4-6 weeks to review the progress of the audit;
  - a *substantiation review* conducted by an independent member of the PAG to confirm there is evidence in the working papers to support the statements made in the draft report;
  - a formal *peer review* of the report again using an independent member of the PAG;
  - a '*fatal flaw*' review of the draft report conducted by an independent member of the OAG. This happens after the substantiation and peer reviews take place, and once the audited entity has commented on the draft report;
  - two edits of the draft report by the Reports and Communications Group;
  - scrutiny by the OAG's Accounting and Auditing Policy QA team;
  - involvement of the OAG management team, as members of the Project Steering Committee for individual performance audit reports or as fatal flaw reviewers; and
  - a review by the Auditor-General as the ultimate arbiter of, and authority for, the content and quality of OAG reports.
- 6.2.58 We are conscious of various positive comments in Post Project Reviews about the value added through the application of these processes, and plainly they represent an important and thorough assurance process. For example, the New Zealand Qualifications Authority performance audit team found having people with no previous involvement with the topic advantageous, and also found their comments very useful. Our own interviews with OAG staff and comments from other external reviewers have revealed,

however, some questioning of procedures such as substantiation and whether, as measured by the effort currently required (substantiation can take several days), and also the level of assurance obtained, they represent the most effective way to safeguard audit quality.

- 6.2.59 As part of the current Performance Audit Process Improvement Project, an assessment is being made of the added value associated with each stage of the performance audit process, including the review mechanisms detailed above. For instance, this work has raised a question about whether, with revised oversight arrangements, there is a need for a separate peer review and fatal flaw review.
- 6.2.60 To give the processes more impact, we would endorse the suggestion reported in the Post Project Review of the audit of the New Zealand Qualifications Authority that there should be provision for substantiation, peer and fatal flaw reviewers to be present at Project Steering Committee meetings (or those of their successor body) to provide for more animated discussion and debate on the quality of the audit under review. As part of the improvements being piloted, following on from the Performance Audit Process Improvement Project, the OAG will be piloting a more active 'fatal flaw' review at the draft report stage of the audit. This will involve the governance team referred to in 6.2.56, assisted by relevant specialists from within the OAG such as the Sector Manager, Substantiator and Peer Reviewer, questioning the audit team on the draft report with regard to areas of risk and likely challenge.
- 6.2.61 In addition to the standard quality control regime that applies to all performance audits, the OAG has in place a comprehensive system of regular external quality assurance processes. The results of these reviews represent one of the key performance measures in the Annual Plan for 2007-08. These include peer reviews undertaken by academic reviewers and other audit offices; in particular, a reciprocal arrangement with the Australian National Audit Office whereby two OAG performance reports are reviewed every two years. In 2007, as referred to elsewhere, the processes underpinning the performance audit function were subject to scrutiny by the OAG's own Accounting and Auditing Policy QA team. There was also a separate internal review by the PAG of the results of 19 Post Project Reviews.
- 6.2.62 In our judgement, based upon our own research and interviews, we would endorse the findings of the various quality assurance processes and reviews (from which we have quoted throughout this Section of our report). These have shown the many measures that are working well across the OAG's performance audit function, and have also signposted ways in which further improvement can be secured.
- 6.2.63 A key part of the quality assurance process is that there should be an independent means to check what actions have been taken. Each June the PAG is required to report to the OAG's Audit and Risk Committee on the outcome of the internal and external reviews and on the actions taken by the Group in response. In addition, an important step in recent years has been the development of a mechanism whereby, instead of the reports for external review being selected by the Group, this is now done in consultation with the Committee, which is also involved in the decision on who should conduct the reviews.
- 6.2.64 In response to a request from the OPC, the Auditor-General has, since 2004, provided the Committee each year with a performance audit evaluation report commenting on the impact of three performance audits selected by the Audit and Risk Committee for internal review by the PAG. This is designed to allow the Committee to assess the



contribution made by the performance audit function to the work of the Office, focussing upon:

- the desired impact of the performance audits;
- Select Committee feedback on reports; and
- external peer review and feedback.

6.2.65 The Annual Stakeholder Feedback exercise offers an important source of independent information about the regard in which the Office is held by Select Committees, Treasury and the New Zealand Society of Local Government Managers. In 2007, the exercise was based on 16 interviews, and asked two main questions to determine stakeholders' satisfaction overall with performance audits, and how useful they felt they were.

6.2.66 While these interviews are very useful information for the Office, there is scope to widen the criteria and related questions in the Annual Stakeholder Feedback survey to garner views on specific aspects of the OAG's performance auditing activities, for example, the coverage of topics, and the quality of recommendations.

6.2.67 The Stakeholder Feedback Interviews make a number of general points about the Office's activities that may have a bearing on the design of the future performance audit work programme including the need to:

- concentrate on the nub of issues, providing a clearer analysis of financial trends from year-to-year and to alert the Select Committees to future capital risks, and;
- clarify the steps it is taking to improve the performance of poorly performing departments.

6.2.68 At present, much of the quality assurance effort is focussed towards the end of an audit or, indeed, after an audit report has been published. We consider there would be merit in targeting more of this resource at earlier points in the audit lifecycle. Resources currently absorbed in the external QA reviews of published reports could be redeployed to instigate an external review process of reports at a draft stage. External review might also be introduced at the planning stage of a performance audit (beyond the internal peer review already in place) to offer some independent assessment of audit scope and whether methodologies proposed are fit for purpose.

### *Suggestions for Improvement*

- **At present, much of the quality assurance effort is focussed towards the end of an audit or, indeed, after an audit report has been published. We consider that there would be merit in targeting more of this resource at earlier points in the audit lifecycle. This, we feel, could bring further depth and rigour to the scope and design of a performance audit and would provide a useful “challenge mechanism” to test the range of methodologies and approaches planned for an audit.**

## **Implementation of Report Recommendations**

- 6.2.69 The effectiveness of performance audit is largely dependent on the effective implementation of its recommendations.
- 6.2.70 Acceptance of, and the responses made by, entities to recommendations in performance audit reports are shown as a key performance measure in the Auditor-General's Annual Plan for 2007-08.
- 6.2.71 At the point when a performance audit report is tabled in Parliament, the OAG offers a briefing to the Finance and Expenditure Committee or the relevant Select Committee. This is sometimes followed by a hearing of the particular Committee, at which evidence is taken from the public entity or entities in question. What happens then depends upon: the reaction of the entity itself; whether a Select Committee hearing was held; and how the OAG itself plans to follow up its work. Unlike other jurisdictions, there is no formal requirement for entities to respond to recommendations made by the OAG.
- 6.2.72 The principal mechanism for follow-up is in practice the briefing provided to the Select Committees in advance of the particular entity's Estimates or Financial Review hearing by the relevant OAG Sector Manager. This is plainly an important accountability mechanism, but it relies for its effectiveness on the strength of the briefing provided. To reinforce this process, the OAG may wish to explore with Select Committees whether a more formal process should be introduced requiring the entity to set out its response to the recommendations made, against which its subsequent actions can be assessed. This would strengthen accountability by placing a clear obligation on public entities to take necessary action. (As part of its programme of reviews in 2008, the OAG's Accounting and Auditing Policy QA team is considering looking at the implementation of the recommendations in performance audit reports.) It would also apply a discipline upon OAG performance audit teams to ensure that their recommendations were practical and capable of implementation.
- 6.2.73 There is also the annual performance audit evaluation to the OPC on the outcome of three reports. This is an important mechanism because it provides structured feedback on the impact of the reports and the actions planned in response. It covers, however, only three reports and it is not clear what actions follow by way of obtaining feedback from the Committee about their views on what is shown. We suggest that the OAG might wish to brief the Committee about the outcome of this quality assurance process to provide for a more proactive dialogue.

### ***Suggestions for Improvement***

- **There is scope to strengthen the processes for following up the recommendations made in performance audits, for example by public entities being invited to set out formally their immediate response to the Office of the Auditor-General's recommendations, and at a later date, for the Auditor-General to review the steps they have taken to implement those recommendations. This would strengthen accountability by placing a clear obligation on public entities to take necessary action. It would also apply a discipline upon the Office of the Auditor-General's performance audit teams to ensure their recommendations were practical and capable of implementation.**

- **There may be a case to enhance the annual Performance Audit Evaluation Report to the Officers of Parliament Committee, for example, by increasing the number of audits covered in the evaluation and, if the Committee so wished, for the Office of the Auditor-General to make a presentation to them in support of the Report.**

### **Follow-up Audits**

- 6.2.74 Beyond follow-up recommendations, the OAG also publishes a small number of follow-up reports revisiting earlier performance audits. These can be prompted by the OAG itself or by a request from another party, for example a Select Committee.
- 6.2.75 Such reports represent an important accountability mechanism allowing the OAG and Select Committees to revisit subjects of continuing concern, or where there is doubt about whether recommendations from a previous performance audit have been taken sufficiently seriously. It was put to us by the OAG that a more immediate way to enhance the impact of the performance auditing function would be to make sure that there are effective mechanisms to ensure that all recommendations are acted upon, with follow-up reports being a useful additional device if needed. (Inevitably, only a limited number of follow-up performance audits are conducted each year, given the many other new and important areas of expenditure for the OAG to examine.)
- 6.2.76 At a practical level, we note that one of the findings of the PAG’s March 2007 review of Post Project Reviews identified some issues around the scope of follow-up audits, and in the difficulty of managing the auditee’s expectations about what might, or might not, be covered. This included where the situation had moved on from the original audit, meaning that a tightly focussed follow up could not readily address current issues. As mentioned earlier, this review also highlighted some difficulties where the “*original recommendations had not been framed in a way to allow easy auditing and had to be re-formulated for the follow up.*”

## **6.3 Good Practice Guides**

- 6.3.1 In addition to performance audits, the OAG has also published a small number of good practice guides. These are produced by different Groups within the OAG. In recent years there have been several guides focusing on the proper handling of conflicts of interest in both the central and local government arenas as well as, for example, Controlling Sensitive Expenditure and Local Authority Codes of Conduct.
- 6.3.2 Good practice guides were well received by stakeholders, in particular by senior staff in entities. They were seen as a useful and an appropriate activity for the OAG to be engaged in, with little risk perceived of a conflict of interest arising between the Auditor-General being theoretically both standard-setter and post-hoc auditor. There was also a general recognition that the authority of such guides could be enhanced where they can be produced jointly with other bodies such as the New Zealand Treasury and the State Services Commission.
- 6.3.3 In our experience, good practice guides have become a common output of audit offices generally, representing a useful way of communicating wider messages arising from their audit work. Perhaps inevitably, some commentators saw the guides as being too general in nature while others felt they were too detailed. Good communication with, and the involvement of, relevant entities would tend to minimise such difficulties.

### *Suggestions for Improvement*

- **When preparing good practice guidance, the Office of the Auditor-General should consider whether such guidance, in some circumstances, would carry added weight and authority if it were jointly prepared and published with other bodies, including the Treasury, the State Services Commission, or the New Zealand Society of Local Government Managers.**

## **6.4 Performance Reporting**

- 6.4.1 Summary performance information on the performance audit function is included in the Auditor-General's Annual Plan and subsequent Annual Report. These include short commentaries on the results of the Stakeholder Feedback Interviews and on the various internal and external quality assurance reviews in the period. There is also a section entitled "*Progress against our Annual Plan*" which lists the reports completed as well as providing explanation of any variations – mainly audits that have been removed or deferred.

## **6.5 Inquiries**

- 6.5.1 Under Section 18 (1) of the Public Audit Act 2001, the Auditor-General has the power to inquire into any matter concerning a public entity's use of resources, either in response to requests from Select Committees, Members of Parliament, Councils or concerned citizens or groups, or on his own initiative.
- 6.5.2 May 2006 saw the introduction of an Inquiries Manual designed to rationalise processes and procedures across the OAG centred around good practice established in earlier inquiries; in particular to provide a consistent decision-making framework for handling requests and, where an inquiry is initiated, indicating how that should be conducted.
- 6.5.3 Ultimately, it is up to the Auditor-General and his Leadership Team to judge the appropriate course of action in response to requests for inquiries; whether to proceed and in what ways. The Inquiries Manual represents an important decision-making tool and is an important means for the Auditor-General to demonstrate, with clear and comprehensive documentation, that processes have been diligently and consistently applied.
- 6.5.4 Requests for inquiries are classified by sector; termed "ratepayer" for local authorities and "taxpayer" for central government. (Requests from Members of Parliament are logged separately.) In 2006-07, the OAG received 250 requests (compared with 228 for the previous year) as follows:
- 72 Taxpayers;
  - 169 Ratepayers; and
  - 9 Members of Parliament
- 6.5.5 Of those, 173 were dealt with informally, where the OAG judged that the request was either not in its power to examine, or that it was a straightforward issue typically dealt with by simple correspondence or telephone call. 77 requests were, however, the subject of a formal inquiry with 76 classified as "routine" and one as "sensitive". There were no "major" inquiries in 2006-07 (compared with seven in the previous year).

- 6.5.6 There are clear processes for monitoring the progress of inquiries. In particular, a report is provided to each Leadership Team meeting on outstanding inquiries and the timeliness of dealing with inquiries, against which progress against performance criteria, as defined in the Annual Plan, can be monitored.
- 6.5.7 As with performance audits, the Auditor-General's Annual Report for 2006-07 includes a section showing details of the OAG's performance in handling inquiries; recording, in particular, the timeliness of the Office in responding to requests for inquiries, and for their subsequent completion. Details of the costs of inquiries were not immediately available.
- 6.5.8 Inquiries are carried out by different OAG Groups (primarily Parliamentary and Local Government) with support often provided by Audit New Zealand and its Special Assurance Services. The PAG also plays a role either in directly undertaking an inquiry, or more usually, in providing support to inquiries undertaken elsewhere in the Office.
- 6.5.9 In these circumstances, where inquiries are conducted by different OAG Groups with, inevitably, different management styles and approaches, the new Inquiries Manual is a particularly important means to help ensure consistency.
- 6.5.10 In practice, it is often the relevant Sector Manager who has prime responsibility for the conduct of an inquiry, but for larger inquiries a discrete team may be necessary. For inquiries that take fewer than 15 hours, there is a general time code under each category of inquiry (that is, Ratepayer, Taxpayer, Parliamentary) with the costs absorbed within the general budget of the relevant Group. Larger inquiries, however, are assigned their own time code for recording the resources used.
- 6.5.11 As with the OAG's performance audits, the 2007 Stakeholder Feedback Report found 100 per cent of respondents satisfied with the Office's handling of inquiries, compared with 75 per cent in 2006. While this is plainly a very important body of stakeholders, it is also a relatively small cross-section of opinion, particularly when many inquiries are prompted by individual citizens. While the inquiries system will not always meet the expectations of often concerned or aggrieved parties, the OAG may nevertheless want to develop the means to canvass a wider body of views, and ask a wider set of questions about the quality of its inquiries work, upon which further development and refinement to the inquiries process can draw.
- 6.5.12 With the exception of the inquiry into election advertising, which because of the unique constitutional circumstances we do not comment upon here, our interviews with MPs, Select Committees and public entities found a high level of satisfaction with the OAG's handling of inquiries. No substantive concerns were raised, only the occasional questioning of whether all the subjects really warranted the scrutiny of the OAG.
- 6.5.13 We reviewed a selection of inquiries from 2006-07, although with 76 out of 77 classed as "routine" and no major inquiries during the year, the evidence base was relatively sparse.
- 6.5.14 In 2006-07, there were, however, two specific quality assurance exercises, which provided a very useful body of evidence. We are also conscious that in October 2007, shortly after our visit, the OAG published a report on a major inquiry into the proposed

- new sports stadium in Dunedin.<sup>7</sup> Given the report's recent publication, we have not sought to judge its content or quality but have reviewed it to see whether there are any useful similarities or differences to highlight between this type of document and performance audit reports.
- 6.5.15 The first quality assurance exercise was a Review conducted in July 2007 by an independent consultant who was also responsible for the November 2006 Governance Review of the Office. This focused on two major inquiries initiated and completed in 2005-06 and involved consideration of the extent to which those inquiries followed the broad approach established in the Inquiries Manual. These inquiries examined Housing New Zealand and Christchurch City Council.
- 6.5.16 The Review commented favourably on the interview and consultation processes adopted in one of the inquiries and concluded overall that nothing emerged from the exercise to suggest any deficiency in the outcome of the two inquiries as a result of the processes each followed. More generally, the Review made a number of recommendations about areas of the Inquiries Manual that might need strengthening, for example, in respect of the need to establish early in an inquiry the expectations and benchmarks that determine the standards against which the actions of public entities are to be assessed. The Review also raised the issue of the importance of compliance with the Manual, and the proper recording of key decisions (for example, in respect of the decision to hold an inquiry, the approval of terms of reference, and completion of the QA processes).
- 6.5.17 Major inquiries are often conducted against tight timescales, driven by the expectations of Parliament and the public. The Review raised the importance of an early and realistic assessment of the trade-off between the time needed to complete the inquiry processes and the time pressure facing the inquiry.
- 6.5.18 A second review, which reported in August 2007, was conducted by the OAG's own Accounting and Auditing Policy QA team. This included an appraisal of the Inquiries Manual itself, together with an assessment of how well the procedures set out in the Manual were applied in practice, based on a sample of 20 inquiries completed in 2006-07 and judged by the OAG to be representative of inquiries more generally. There was only one major inquiry during the period on Parliamentary Advertising Expenditure. We consider, however, that given the uniqueness of the subject and its related high public and political profile, this report does not represent a typical inquiry.
- 6.5.19 The review concluded that appropriate systems and controls were in place. An assessment against 10 high level risks (in particular a loss of credibility and reputation, and a loss of stakeholder confidence), found that the likelihood of each was low, on the basis of the identified key controls in place. The review did, however, identify a need in some inquiries for more documentation to positively demonstrate compliance with the Manual. Where an inquiry was not instigated, the review concluded that a clear reason had been given to the correspondent.
- 6.5.20 While we recognise the importance of proper processes being evidenced against the Inquiries Manual, it may be an unnecessary duplication, particularly in smaller inquiries, to separately document the rationale for decisions when these are clearly recorded in the final response.

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<sup>7</sup> Inquiry into Dunedin City Council and Otago Regional Council's Funding of the Proposed Stadium under cover of a letter from the Auditor-General to Mayor Peter Chin and Chair Stephen Cairns, dated 24 September 2007.

- 6.5.21 It is apparent that many of the audit processes and disciplines are the same for inquiries and performance audits. For example, for each there is an internal peer review and substantiation and fatal flaw reviews. As a general principle, both need to conform to the same Auditing Standards. While they are plainly different products, this does raise the question of whether the two disciplines can learn from one another and whether there is more scope for knowledge transfer between the different Groups. This would include consideration by the OAG of the applicability of the various suggestions for improvement identified for performance audits earlier in this Section.
- 6.5.22 When developing the forward programme of performance audits, Sector Managers and the PAG should consider whether any topics lend themselves to an inquiry-style approach. For instance, the shorter timescale of inquiries and the need for the OAG to provide a clear expression of opinion requires disciplined and focussed evidence gathering around clearly defined issues.
- 6.5.23 The Dunedin Stadium report was in the form of a 17 page letter, considerably shorter than the average performance audit report. By including some of these shorter studies, the PAG would be able to offer a wider range of products and increase the flexibility of its approach. This would also be in keeping with the reported wishes of Select Committees for a more varied diet of small, medium and large performance reports produced more quickly.

#### *Suggestions for Improvement*

- **The Office of the Auditor-General may wish to develop the means to canvass a wider body of views concerning satisfaction with the handling of inquiries, and ask a wider set of questions about the quality of its inquiries work, in order to further develop and refine the inquiries process.**
- **Consideration should be given to strengthening areas of the Inquiries Manual, for example in respect of the need to establish early in an inquiry the expectations and benchmarks that determine the standards against which the actions of the public entities are to be assessed.**
- **The Performance Audit Group should consider whether any topics for future audit lend themselves to an inquiry-style approach. By including some of these shorter studies the Group would be able to offer a wider range of products and increase the flexibility of its approach.**

## 7. Suggestions for Improvement

The following are the main suggestions for improvement in the context of the three broad areas in which the report has been structured. The Auditor-General's response to each suggestion is set out in the box which follows it.

### 7.1 Governance and Management

- 7.1.1 A task force should be established to carry out planning and preparatory work on the proposed move to a new building housing both the Office of the Auditor-General and Audit New Zealand Business Units. Adequate funding needs to be provided for the move. Regular communication with, and involvement of, all those affected will be important for a successful outcome.

We agree that the OAG and Audit New Zealand should co-locate. We have raised the possibility of relocation with OPC. The final outcome will depend on the quality of our business case to support the move.

- 7.1.2 It is suggested that consideration be given to having a performance audit undertaken of the Office by the External Auditor in the next year.

We are considering this suggestion and this proposal has also been passed on to our Audit and Risk Committee for their consideration. (The Auditor-General has agreed that all added assurance work undertaken by the auditor must have the Audit and Risk Committee's support.)

- 7.1.3 High priority should be given to the completion and rolling out of the organisation's risk management policy and updated business continuity plan in the current financial year.

Agree. Drafts of both have been completed and are in the process of being rolled out.

- 7.1.4 The leadership teams should maintain a strong focus on the implementation of a knowledge management system that will meet the needs of the Office of the Auditor-General and Audit New Zealand.

Agree.

- 7.1.5 Close attention should be paid to resourcing the Research and Development function at a level capable of supporting the strategic decision-making critical to the credibility and effectiveness of the organisation, as well as to its ability to respond appropriately to a fast-changing environment.

Agree. A senior level appointment has been made since the Peer Review Team was here, but the Research and Development unit is still under-staffed.

- 7.1.6 The Office of the Auditor-General and senior Parliamentary Services managers should continue their efforts to strengthen the relationship between the Office of the Auditor-General, the Officers of Parliament Committee and key parliamentary Select Committees.

Agree.



## 7.2 Financial Statements and Assurance Auditing

- 7.2.1 The retention and recruitment of a small number of key staff is a risk that needs to be specifically covered in the Risk Management Plan for the Office.

This risk is now included as one of the key strategic risks in our Risk Management Plan.

- 7.2.2 The direction, scope and breadth of the enhanced financial statements audit in the public sector should be evaluated as a matter of priority by the Office of the Auditor-General in relation to its own performance and for the information of its stakeholders, particularly Parliament.

We consider that a public sector audit differs from the financial statements audit carried out in the private sector. The Public Audit Act 2001 recognises that difference, in that it envisages that the Auditor-General will publish auditing standards additional to the NZICA standards (section 23), which the Auditor-General does. Further, the various statutes (eg Public Finance Act, Crown Entities Act, Local Government Act) which govern the accountability of public entities require those entities to report more than their financial performance, and require the Auditor-General to audit that information.

The “direction, scope and breadth” of the annual audit work is thus mandated by statute, and was thoroughly considered by Parliament when the Public Audit Act was passed in 2001. Parliament has also recently considered the reporting requirements for most public entities – for local government in 2002 and for government departments and Crown entities in 2004.

The intention in adding requirements for the annual audit is to gain more value from the audit. However, we recognise the risk of “brief creep” and have clarified the responsibility within the OAG for ensuring that it does not occur.

- 7.2.3 The Office of the Auditor-General should address the issue of public sector entities having the same Audit Service Provider for periods approaching, and exceeding, twelve years in the interests of preserving audit independence and maintaining the efficiency and effectiveness of the entities concerned.

The Auditor-General reviews the position on an annual basis and is satisfied that the current position is acceptable. The fragility and small size of the auditor pool in New Zealand as well as the geographic dispersal of the audit entities are taken into account. Appointed Auditors are replaced every six years (five for companies listed on the Stock Exchange).

- 7.2.4 It is suggested that, in the selection of Appointed Auditors, the assessments against each selection criterion should be documented and summarised in the relevant submission to the Auditor-General.

Agree. This is now being done.

- 7.2.5 It would be prudent for the Office of the Auditor-General to minimize the risks associated with being seen not to comply with the main requirements of the government's procurement policy.

The Government's procurement policy does not apply to the OAG or some other elements of the public sector (eg the Health Sector). We consulted with FEC before introducing the current allocation process. The key driver for appointments is quality but we also make sure that the principles of openness, value for money and fairness are satisfied in our allocation process.

- 7.2.6 The desirability of merging at least some of the technical resources of Audit New Zealand and those of the Office of the Auditor-General should be further investigated for better operational effectiveness and efficiency, particularly where the skills involved are difficult to recruit and retain.

This was considered in detail in 2005/06 when the Professional Practice Group was established in Audit New Zealand. While some resources are shared eg Legal and Corporate Services, it was decided that the needs of the Office were best met by retaining separate technical teams. We will continue to ensure the two teams do work together when that is the best use of resources – as has been the case with preparing for the adoption of IFRS.

- 7.2.7 The structure of audit operations in Audit New Zealand could be more efficient if audit responsibilities were assigned in a manner that would permit greater specialisation amongst the Directors and staff and if any duplication between Audit New Zealand and the Office of the Auditor-General were reduced. The result would most likely be greater economies of scale, greater efficiencies in the performance of the audit work and improved identification of audit issues.

The concept of specialisation was taken into account during the recent reallocation of Directors to audits. However, given the breadth of Audit New Zealand's portfolio of audits and the geographic spread of audits, complete specialisation would not be cost effective. The roles of sector specialists in Audit New Zealand and Sector Managers in the OAG have a different focus. The former are focused on doing effective audits at an entity level whereas the latter have supporting Parliament as their primary focus. They do work collaboratively.

- 7.2.8 Although the Audit New Zealand Quality Control Manual includes a wide range of policies and follows the recently implemented international standard on quality control, it does not provide sufficient information with respect to policies surrounding recruitment, performance evaluation, career development, promotion, and auditor rotation. During interviews, it was evident that such information exists but it is not part of the Quality Control Manual that can be easily accessed. This is a matter that requires attention.

Agree. This has been attended to.

- 7.2.9 While it is noted that Audit New Zealand has appropriate audit tools and audit methodology to conduct quality audits and that staff are more focussed on their role, more effort is required to ensure that Audit New Zealand executes its new methodology and policies in a manner that will continue to deliver high quality professional services and adapt to the international changes in the accounting and auditing profession. In the opinion of the Peer Review Team, the response to these challenges should be for Audit New Zealand to continue its efforts to train all of its staff in the elements of the new

audit methodology and practices but to also hold separate in-depth training on key elements of that methodology and separate training sessions customised and targeted for senior staff.

Agree. Targeted training is scheduled for May – June 2008.

- 7.2.10 It is incumbent on the Office of the Auditor-General to ensure it remains independent of implementation issues related to local government to retain its objectivity and cautious scepticism as part of audit responsibilities and also be seen to be doing so.

Noted.

- 7.2.11 The Office of the Auditor-General is strongly encouraged to address comprehensively the full range of issues emerging from the recent quality assurance review covering the LTCCP.

This has been done as part of the methodology revision that was signed off in March 2008.

### **7.3 Performance Auditing, Good Practice Guides and Inquiries**

- 7.3.1. The Office of the Auditor-General should consult with the Officers of Parliament Committee and the Finance and Expenditure Committee to determine the value they would see in a more proactive discussion on the Office’s draft performance audit work programme. This would include commenting on the reasons for specific proposals for performance audits or studies not being included in the final programme.

All Select Committees are consulted on the draft work plan. This year we had a detailed discussion with FEC on the draft plan and suggestions for additional projects were provided to us. As we did last year, we are formally responding to each committee in relation to the suggestions they have made. For our 2008/09 work programme we are hoping to involve the committees much earlier to seek their suggestions on what we could include in the work programme.

- 7.3.2. The Office of the Auditor-General may wish to discuss with heads of major public entities how the existing consultation arrangements on the Office’s performance audit work programme might be further developed and refined; and, where a performance audit is pursued, whether there would be merit in more direct contact with the relevant Chief Executive during the key design and scoping stages of the audit.

We will continue to review our process for consultation on our proposed work programme. We note that, as part of the scoping stage for possible audits, we do consult the heads of the entities which would be affected by an audit.

- 7.3.3. The Office of the Auditor-General should undertake an analysis of Post Project Reviews covering performance audit reports published in 2007-08 to determine how the closer involvement of performance audit teams with the scoping of performance audits has paid dividends. The Office of the Auditor-General should also continue to explore new and innovative ways to get to the bottom of topics, such as making further use of “issue analysis” meetings, to make sure that it has full knowledge of entities’ plans and vice versa.

An analysis of the Post Project Reviews will be undertaken. We also agree to the second suggestion.

- 7.3.4. Where an entity's performance is assessed against internally set standards, there is a risk that performance audit reports may not encourage the stretching of performance. At the audit planning stage, the PAG should test to see whether the methodologies proposed for the audit will yield sufficient independent benchmarking, research and analysis to provide an objective assessment of the auditee's activities and performance, including whether the immediate targets and standards that the audited body has set for itself are sufficiently challenging.

We do look externally for good practice. However, the need to do so will be stressed in our internal guidance.

- 7.3.5. The Office of the Auditor-General may wish to be more ready to offer an opinion on whether it considers that, where particular information is unavailable, the entity should have had that information available for analysis and decision-making.

Agree. The message is generally implicit – we will make it explicit.

- 7.3.6. More financial analysis would be helpful in some reports, particularly those that examine particular programmes and initiatives.

Agree. We will take steps to ensure that the necessary expertise is available to each audit team.

- 7.3.7. More quantification of the costs and benefits of government programmes would help to determine whether entities are choosing the most cost-effective means of achieving their objectives.

Agree.

- 7.3.8. The structure and content of reports could be altered to reduce descriptive content and give more prominence to key findings and analysis in direct support of recommendations.

The structure of reports will be reconsidered. We need, though, to ensure that reducing the descriptive content does not reduce the reader's understanding of the topic under consideration.

- 7.3.9. Reports could include more explicit explanation of their scope.

Agree. We will take care to explain more clearly the focus of our audit, and any limitations on its scope.

- 7.3.10. In addition to recent new instructions to performance audit teams that recommendations should be significant and targeted, we would add that they should also be *measurable*: setting out wherever possible clear timescales for action by the entity, and by defining the criteria against which the impact of a recommendation should be assessed.

Agree.

- 7.3.11. With 14 performance audits to deliver in 2007-08 and a core audit staff of around 15, the Office of the Auditor-General might consider reviewing staffing levels for performance audits, looking in particular at continuity and at its capacity to do justice to the range and number of audits tackled each year

Agree. Resourcing of the team needs to be under continual review.

- 7.3.12. The Office of the Auditor-General should investigate whether a better balance can be struck between the effort and resources committed to the conduct of a performance audit and that committed to its review.

Agree. The Performance Audit Process Improvement Project that we have initiated has focused on this.

- 7.3.13. At present, much of the quality assurance effort is focussed towards the end of an audit or, indeed, after an audit report has been published. We consider that there would be merit in targeting more of this resource at earlier points in the audit lifecycle. This, we feel, could bring further depth and rigour to the scope and design of a performance audit and would provide a useful “challenge mechanism” to test the range of methodologies and approaches planned for an audit.

We will discuss this suggestion with our Australian counterparts (as possible providers of quality assurance). We need to ensure though that additional QA would not add to the length of time (and hence the cost) of the audit.

- 7.3.14. There is scope to strengthen the processes for following up the recommendations made in performance audits, for example by public entities being invited to set out formally their immediate response to the Office of the Auditor-General’s recommendations, and at a later date, for the Auditor-General to review the steps they have taken to implement those recommendations. This would strengthen accountability by placing a clear obligation on public entities to take necessary action. It would also apply a discipline upon the Office of the Auditor-General’s performance audit teams to ensure their recommendations were practical and capable of implementation.

Noted. We do offer a briefing on each performance audit to the relevant Select Committee, and we consider appropriate follow-up of performance audit recommendations as part of our work planning. We will look at establishing a more systematic approach to follow-up.

- 7.3.15. There may be a case to enhance the annual Performance Audit Evaluation Report to the Officers of Parliament Committee, for example, by increasing the number of audits covered in the evaluation and, if the Committee so wished, for the Office of the Auditor-General to make a presentation to them in support of the Report.

Noted. We will discuss this suggestion with the Speaker as Chair of the Committee.

- 7.3.16. When preparing good practice guidance, the Office of the Auditor-General should consider whether such guidance, in some circumstances, would carry added weight and authority if it were jointly prepared and published with other bodies, including the Treasury, the State Services Commission, or the New Zealand Society of Local Government Managers.

We acknowledge the benefit of joint publications in some circumstances, and we will consider working jointly with other agencies where appropriate. We currently consult many bodies, including those named, before publishing our guides. However, our guides are usually intended for the whole public sector, and no other agency has that breadth of responsibility.

- 7.3.17. The Office of the Auditor-General may wish to develop the means to canvass a wider body of views concerning satisfaction with the handling of inquiries, and ask a wider set of questions about the quality of its inquiries work, in order to further develop and refine the inquiries process.

We are not sure how we would do this. Many inquirers and audit entities do give us feedback if they do not like the outcome of the inquiry. Their views are considered.

- 7.3.18. Consideration should be given to strengthening areas of the Inquiries Manual, for example in respect of the need to establish early in an inquiry the expectations and benchmarks that determine the standards against which the actions of public entities are to be assessed.

Agree. Often, though, there is a need for considerable work to understand the issue before we decide whether to proceed with an inquiry.

- 7.3.19. The Performance Audit Group should consider whether any topics for future audit lend themselves to an inquiry-style approach. By including some of these shorter studies, the Group would be able to offer a wider range of products and increase the flexibility of its approach.

The suggestion is noted and accepted, though we think it is a task for the Operations Group, not the PAG. Some of the articles in our Central and Local Government annual reports are of this nature.

## 8. Note of Appreciation

- 8.1. The Review Team is very grateful for the high level of co-operation and support provided by the Controller and Auditor-General, Mr Kevin Brady, and by the Deputy Controller and Auditor-General, Ms Phillippa Smith. Both provided frank and open comments and responses as did the many staff of the Office that were interviewed. As well, the Team would like to acknowledge the time and insights provided for the Review by the wide range of people outside the Office, including Parliamentarians. While the Review Team takes full responsibility for the content of this Report, in particular for its analyses, conclusions and suggestions for improvements, we owe a debt of gratitude to all those involved for facilitating the conduct and finalisation of the Peer Review. The Team itself worked well together which ensured that tight timetables were met and that the ACAG peer review approach was properly conducted and the Terms of Reference were fully covered. The Review Team Coordinator commends the individual efforts made and the results achieved.

## **TERMS OF REFERENCE**

The review will assess the efficiency and effectiveness of the Office, in particular how well the Office is achieving the outcomes it seeks.

### **The review will cover:**

- the governance of the Office, including the respective roles of and relationship between the Office of the Auditor-General and Audit New Zealand;
- the conduct of financial audit engagements, including the audit of Long-term Council Community Plans;
- the conduct of performance audits, inquiries, the Controller function, and other work performed by the Office of the Auditor-General, including the support of select committees;
- general management of the Office, including the organisation of resources, the allocation of audits, and setting and monitoring of audit fees;
- the operation of the Office's quality control systems;
- the Office's relationships with its primary stakeholders, in particular Parliament; and
- such other matters as the review team considers relevant.

The review will generally follow the approach developed for the Australasian Council of Auditors-General for Peer Reviews and Voluntary Developmental Quality Assurance Reviews.

### **Timing and reporting**

The review will take place in September 2007. The reviewers intend completing their report by 31 March 2008.

## **REVIEW TEAM MEMBERS**

- 1. Pat Barrett**, AO. B.Ec (Qld), FCPA, FICA, FCIS, FIPAA, FRMIA (Hon).  
Senior Fellow, Australian National University  
Formerly Auditor-General, Australian National Audit Office (1995-2005)
- 2. Neil Walter**, CNZM. MA (1<sup>st</sup> Hons) (Auckland), Certificate of Advanced Management, (Cranfield University).  
Chair, Environmental Risk Management Authority  
Chair, NZ Broadcasting Commission  
Formerly Secretary, New Zealand Ministry of Foreign Affairs and Trade
- 3. Mark Davies**, BA (Leeds). Member CIPFA  
Director of Cross-Government Studies, UK National Audit Office  
Formerly Private Secretary to the Comptroller and Auditor-General  
UK National Audit Office
- 4. David McKean**, B.Ec (Monash) M.Admin (Monash). Member of CPA Australia  
Director, Yarralumla Consulting Pty Ltd  
Formerly Executive Director, Australian National Audit Office  
(Team Member undertaking Peer Review of the New Zealand Office of the Auditor-General and Audit New Zealand in 2001)
- 5. Clyde MacLellan**, B. Business Administration (Acadia). Chartered Accountancy Diploma.  
Assistant Auditor General, Office of the Auditor-General in Canada  
Formerly Lecturer (Accounting and Auditing) Saint Mary's University (Halifax)



## **INTERVIEWS CONDUCTED**

### **Familiarisation Interviews with Review Team Coordinator**

- 23/11/2006  
and  
24/11/2006 Kevin Brady (CAG) and Phillippa Smith (DCAG)
- 23/11/2006 Terry McLaughlin (Executive Director, Audit New Zealand)
- 23/11/2006 Matthew Reid (Corporate Services, OAG)
- 23/11/2006 Greg Schollum (AA-G, Accounting and Auditing Policy, OAG)
- 23/11/2006 ANAO Peer Review Team – PAG (Alex Wilkinson and Stephen Cull) in Wellington
- 13/12/2006 ANAO Peer Review Team (Alex Wilkinson and Stephen Cull) in Canberra
- 21/02/2007 David Butler (Commissioner of Inland Revenue)
- 21/02/2007 Mark Prebble (State Services Commissioner)
- 21/02/2007 Geoff Dangerfield (Chief Executive, Ministry of Economic Development)
- 21/02/2007 Peter Hughes (Chief Executive, Ministry of Social Development) and Graeme Carruthers (Deputy Chief Executive Risk and Assurance)
- 21/02/2007 Kevin Brady (CAG) and Phillippa Smith (DCAG)
- 22/02/2007 Ken Warren (Chief Accounting Adviser) and Tyson Schmidt (Treasury)

### **Interviews conducted by Review Team Members**

- 11/09/2007 Jo Smaill (Audit NZ Director, Audit New Zealand)
- 12/09/2007 Dean Reynolds (CST Manager - Project Office, OAG)
- 12/09/2007 Lynley Jenkins (CST Manager - Reports Group, OAG)
- 12/09/2007 Maria Viviers (CST Manager - Finance, OAG)
- 12/09/2007 Terry Hutchins (CST Manager - HR, OAG)
- 12/09/2007 Peter Grant (Acting AA-G - CST, OAG)
- 12/09/2007 Chong Lim (General Manager, Professional Practices/Audit, Audit New Zealand)
- 13/09/2007 Nicola White (AA-G - Legal, OAG)
- 13/09/2007 Terry McLaughlin (Executive Director, Audit New Zealand)

13/09/2007 Greg Schollum (AA-G - Accounting and Auditing Policy, OAG)

13/09/2007 Graham Baker (AA-G - Performance Audits, OAG)

17/09/2007 Kevin Brady (with Phillippa Smith and Greg Schollum, OAG)

17/09/2007 Ann Webster (AAG - Research & Development, OAG)

17/09/2007 Greg Schollum (AA-G - Accounting and Auditing Policy, OAG)

17/09/2007 John Whitehead (Secretary to Treasury)

17/09/2007 Bruce Simpson (New Zealand Police, GM Finance and Planning)

18/09/2007 Mark Maloney (Audit New Zealand)

18/09/2007 Graham Baker (AA-G - Performance Audit, OAG)

18/09/2007 Alex Skinner and Souella Cumming (KPMG)

18/09/2007 Maarten Wevers (Department of Prime Minister and Cabinet)

19/09/2007 Hon Margaret Wilson (Chair, Officers of Parliament Committee)

19/09/2007 Nicola White (AA-G - Legal, OAG)

19/09/2007 Rodney Hide MP (Leader, ACT Party)

19/09/2007 Wendy Venter (AA-G - Parliamentary Services, OAG)

19/09/2007 Robert Cox, Audit New Zealand

19/09/2007 Wendy Venter (AA-G - Parliamentary Services, OAG)

19/09/2007 John Pocock, Director of Risk, NZ Customs Service

19/09/2007 Bruce Robertson (AA-G - Local Government)

19/09/2007 Eugene Bowen, Local Government New Zealand

19/09/2007 Megan Wassilieff, Audit New Zealand

19/09/2007 Tony Frankham, Chair, Audit and Risk Committee

19/09/2007 Neil Cherry, CFO, Wellington City Council

20/09/2007 Garry Muriwai (CEO) and Denise Bovaird (President, Institute of Chartered Accountants of New Zealand)

20/09/2007 Grant Taylor, Ernst & Young

20/09/2007 Sylvia van Dyk (Director, Quality Assurance, OAG)

20/09/2007 Peter Schuyt (CFO, New Zealand Post)

20/09/2007 Lynley Jenkins (CST Manager - Reports Group, OAG)

20/09/2007 Fergus Welsh (CFO, Ministry of Economic Development)

20/09/2007 Brett Warwick (CFO, New Zealand Fire Service)

20/09/2007 Shane Jones (Chairperson, Finance and Expenditure Committee)

20/09/2007 Hon Peter Dunne (Leader, United Future Party)

21/09/2007 Audit New Zealand (Auckland)

21/09/2007 Andrew McKenzie (GM, Finance, Auckland City Council)

21/09/2007 Wendy Venter (AA-G - Parliamentary Group)

21/09/2007 Nicola White (AA-G - Legal, OAG)

21/09/2007 Kevin Brady (CAG)

21/09/2007 Phillippa Smith (DCAG)

24/09/2007 Steve Chadwick (Chairperson, Local Government and Environment Committee)

24/09/2007 Jan-Marie du Plessis (Work and Income)

24/09/2007 Sandy Dawson (Ministry of Health)

25/09/2007 Peter Grant (Acting AA-G - CST)

25/09/2007 David Smith (CEO, Society of Local Government Managers)

25/09/2007 Dean Reynolds (CST Manager - Project Office) and Phillippa Smith (Deputy Auditor-General)

25/09/2007 Rt Hon Winston Peters (Leader of NZ First Party)

25/09/2007 Teneti Ririnui (Senior Performance Auditor, OAG)

25/09/2007 Ann Kilpatrick (Information Manager, Professional Practices Group, Audit New Zealand)

25/09/2007 Nicola White (AA-G - Legal, OAG)

25/09/2007 Mike Rosser (Director, Auditor Appointments)

25/09/2007 Todd Beardsworth (Director, Accounting Policy)

25/09/2007 Roy Glass (Director, Auditing Policy)

25/09/2007 Nick Johnston (Manager, Quality Assurance)

26/09/2007 Helen Chandelle (Senior Performance Auditor, OAG)

26/09/2007 David Press (Senior Performance Auditor, OAG)

26/09/2007 Kevin Brady (CAG) and Phillippa Smith (DCAG)

26/09/2007 Leanne Arker (Senior Performance Auditor, OAG)

26/09/2007 Pat Hoy (Senior Performance Auditor, OAG)

26/09/2007 Sarah Lineham (Sector Manager, Local Government, OAG)

26/09/2007 Kumar Aravinda (Partner, CST Nexia)

27/09/2007 Wendy Venter (AA-G - Parliamentary Group)

27/09/2007 Maria Viviers (CST Manager - Finance, OAG)

27/09/2007 Peter Grant, (Acting AA-G, CST, OAG)

27/09/2007 Terry McLaughlin, (Executive Director, Audit New Zealand)

27/09/2007 Chong Lim/Ann Kilpatrick (Audit New Zealand)

27/09/2007 Mark Maloney, (Audit New Zealand)

28/09/2007 Pania Gray, (Sector Manager, Parliamentary Group, OAG)

28/09/2007 Andrew McConnell, (Sector Manager, Parliamentary Group, OAG)

28/09/2007 Tony Uttley, (Sector Manager, Parliamentary Group, OAG)

28/09/2007 Kevin Brady (CAG) and Phillippa Smith (DCAG)

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11. **“Report by the Independent Auditor of the Australian National Audit Office on the Results of ‘Value for Money’ provided by the ANAO”**. Independent Auditor (Mr Michael Coleman). Canberra. 24 June, 2004.
12. **“Performance Audit of the Victorian Auditor-General and the Victorian Auditor-General’s Office”**. Conducted by Mr John Phillips (Acumen Alliance). Report to the Public Accounts and Estimates Committee, Parliament of Victoria. December, 2004.
13. **“International Peer Review of the Performance Audit Practice of the Office of the Auditor-General of Norway”**, November 2005.
14. **“Review of the Report on the Performance Audit of the Victorian Auditor-General’s Office”**. Public Accounts and Estimates Committee. 68<sup>th</sup> Report to the Parliament, Melbourne. March, 2006.
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## **BACKGROUND ON THE NEW ZEALAND PUBLIC SECTOR**

### **The Public Management Environment**

1. The arrangements that characterise New Zealand's public management system were set in motion by the major reforms of the late 1980s and 1990s. The State Sector Act of 1988 and the Public Finance Act 1989 initially provided the two principal statutory vehicles for the reforms. Under the State Sector Act:
  - the respective roles of Ministers and chief executives were clarified, with Ministers becoming responsible for what activities departments undertook and chief executives responsible for how these activities were delivered, establishing clear vertical accountability arrangements
  - the employment arrangements for public servants changed, with chief executives of individual departments becoming responsible for employing staff, including setting pay and conditions.
2. The Public Finance Act 1989 made chief executives responsible for the financial management of their departments and replaced detailed central controls with financial delegations tailored to departmental circumstances. It redefined the appropriation process from control of inputs to purchase of outputs; specified a new set of financial instruments for accounting to Parliament, including aggregated Crown financial statements prepared on an accruals basis; required reporting on the net worth (assets less liabilities) alongside conventional cash flow reporting; and introduced incentives for responsible management of assets and liabilities, notably a capital charge to reflect the opportunity cost of asset holdings.
3. Other major features of the reforms included the withdrawal of the State from a range of quasi-commercial activities, either by privatising them or contracting them out, and the reorganisation of government departments. These changes altered the configuration of the State sector from a small number of large, multi-functional departments to a larger number of smaller, more specialised departments. The following themes guided the reformers:
  - separation of purchase and ownership responsibilities
  - separation of policy and operational functions
  - separation of funders, purchasers and providers
  - encouragement of competition between service providers.
4. These major structural and systemic changes were followed by a period of consolidation during the 1990s. In 1994 the Fiscal Responsibility Act built on the public finance framework, establishing a set of medium and long-term fiscal reporting requirements to provide a context for short-term fiscal management and to encourage greater transparency around fiscal policy.
5. A major change in New Zealand's operating environment which occurred during the 1990s was the introduction to New Zealand's electoral system of the mixed member proportional representation system (MMP) in 1996 to replace the first past the post system. This has meant substantial changes to the ways in which government agencies work in supporting Ministers, to respond across party lines in developing policy and service delivery options.

6. The 1990s saw particular attention paid to the conduct and integrity of State servants, with the SSC publishing the first Public Service Code of Conduct in 1990. The guidance material called *Principles, Conventions and Practices* was developed in the mid 1990s and this contributed to an updated code of conduct in 2000. This momentum continued into the 2000s with the establishment of the State Sector Standards Board in 2000 which developed the *Statement of government Expectations of the State Sector* which was endorsed by Ministers and issued in 2001. In 2004 the mandate of the State Services Commissioner was extended to much of the State Services for the setting of minimum standards of integrity and conduct (State Sector Amendment Act (No 2)).

### **Crown Entities**

7. Over the last 15 years the Crown entities sector has increased in size and importance. Crown entities now classified as groups of Crown Agents, Autonomous Crown Entities, Independent Crown Entities, and Crown Entity Companies. Each group represents relative degrees of distance and independence from government decision-making. They constitute a far from homogenous group of government agencies, both by design and by function. Although they mostly engage in regulatory or operational activities, some have policy functions. Taken together, they constitute an important and substantial service delivery arm of government, accounting for \$38 billion of the Crown's physical assets (over two thirds) and more than 50% of total government expenditure, and employing 55% of the State sector workforce (nearly four times the size of the core Public Service).
8. As the Crown entity sector has grown in size and complexity, the governance and management challenges have increased too. A programme of work was initiated in 1999 to address this. Given further impetus by the Review of the Centre, this work led to the Crown Entities Act 2004. This statute represents a significant development in the architecture of the New Zealand public management system. It introduced a consistent framework for the establishment, governance and operation of Crown entities and clarified the accountability relationships between Crown entities, their boards and Ministers.

### **Recent Developments**

9. There have been a range of measures and actions taken to improve performance in the State sector in recent years. In 2002 the report of the *Advisory Group on the Review of the Centre* sought to evaluate and refresh New Zealand's public management system to ensure that it remained fit for purpose to deal with challenges. The outcome of the review was an extensive work programme that involved:
  - setting up cross-agency "Circuit Breaker"<sup>8</sup> teams designed to solve complex problems
  - a project to provide Ministers with a stronger way of shaping departmental priorities which became known as the *Managing for Outcomes* initiative
  - a series of human resource reforms including the development of an overarching HR framework; enhanced investment in training and development that led to the establishment of the *Senior Leadership and Management Development Programme*, the establishment of the Victoria University of Wellington School of Government and New Zealand members of the Australian and New Zealand School of Government (this change was also reflected in the State Sector Amendment Act (No 2) 2004).

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<sup>8</sup> "Circuit Breakers" involved three teams to look at ways of delivering better results on family violence, truancy and skilled refugee and migrant settlement.

10. In 2004 the Public Finance Amendment Act integrated the Public Finance and Fiscal Responsibility Acts into a single statute. Other changes in the Act removed unnecessary restrictions to collaboration among agencies, and paid more attention to outcomes and capability.
11. There has been a move to strengthen the performance of some agencies by placing them within larger departments or ministries and to bring policy and operations closer together in some sectors, e.g. education, justice and social development. Some functions have been returned to public ownership (such as elements of transport infrastructure), or moved closer to Ministers (for example aspects of broadcasting and social housing).
12. Other initiatives include identification of the need for sectors to work more deliberately and effectively together, with one agency to take the lead in ensuring this happens. For example the *Education Sector Review* in 2005 suggested the Ministry of Education be designated the lead agency for the sector to implement the recommendations of the report.
13. The introduction of three themes (economic transformation, families young and old and building national identity) for collective action by the State sector represents an initiative by Ministers to focus the whole State sector on specific priorities. These require collaborative action on multiple work streams by multiple agencies and sector leaders have been appointed for each theme to help facilitate this work. More recently Ministers have decided that budget cycle processes for the 2007 Budget should give more weight to results, building on the themes initiative.
14. Another systemic initiative to improve performance was the introduction of Development Goals by the State Services Commission in 2005. The overall goal – “a system of world class professional State Services serving the government of the day and meeting the needs of New Zealanders” is intended to address how the State sector is arranged and performs. Six goals are identified to give effect to this aim. They are: Employer of Choice, Excellent State servants, and Networked, Coordinated, Accessible and Trusted State Services.
15. Particularly pressing challenges driving change include:
  - increased emphasis on the distinct position of metropolitan Auckland
  - the ongoing need for infrastructure renewal and reinvestment, partly but not only related to Auckland’s demand
  - a requirement for better interaction between central government, local government and third sector organisations.
16. Partly in response to these challenges, several initiatives have been introduced to improve State sector performance at sector and system levels. These initiatives include the following new institutional arrangements as a pragmatic response to performance problems:
  - new arrangements to coordinate policy and delivery in some regions (e.g. Government Economic and Urban Development Office – joined up Auckland office for Ministry of Economic Development, Ministry for the Environment, Department of Labour and Transport), or to drive critical strategic work that cuts across sectors and agencies (such as work on climate change)
  - creating new agencies with both regulatory and operational functions such as the Electricity Commission
  - a series of sector, baseline and expenditure reviews (this review is one in this series).



## **Emerging Challenges**

17. New Zealand is more diverse than ever before, across a range of dimensions – ethnicity, culture, family structures, levels of assets and incomes. An important dimension of State sector performance is having the capability to respond effectively to this diversity, especially the effects over time of changing demographics, and global trends and developments including in technology.
18. There are increasing expectations that governments can solve, or substantially contribute to solving, a range of complex problems which require the collaboration of other actors, e.g. reducing violence within families, dealing with the low attainment tail in education and reducing obesity among children.
19. As in similar jurisdictions, people in New Zealand have more control and autonomy over their lives now. They expect more say in the factors that affect their choices of where to invest and what to consume, and in decisions about what services they receive from government. They also have higher expectations about the quality of services and, because government services are compared with the best of the private sector, the bar for State provision is set higher. Users and consumers of services are quicker to assert their rights. Targeting and customisation to user needs and preferences is increasingly replacing “one size fits all” service provision based on assumptions of homogeneity.
20. The public in general, and special interest groups within that, have much greater and faster access to information than ever before. ICT also assists new organisational structures and networks to become established and sustained. Many interest groups now have better organising ability and information sources than government itself.
21. Changes in these areas have profound implications for how the State sector engages with New Zealanders now and in the future.

## **International Better Practice**

22. New Zealand is not alone in looking for ways to improve the performance across the State sector. New Zealand ranks well internationally in terms of financial management and integrity and ethical standards of its State servants, and this helps create trust in government. It has been slower, however, than some other jurisdictions to adopt a comprehensive results focus and to engage citizens and consumers in its systems and processes. Like other jurisdictions, New Zealand has wrestled with the challenge of embedding innovation and ongoing learning as standard processes within the public management system.
23. International practice points to three areas where central agencies can take a stronger role in performance management. These are a strong results focus (UK, Canada and Australia); engagement with citizens (Canada) and focus on consumer “voice and choice” (UK); and realistic experimentation and learning to improve service delivery (UK and Canada).
24. The UK has used a range of measures to focus the system better on results, notably through the use of targets and taskforces (called Policy Action Teams) to deal with “wicked issues” and the use of citizens’ charters. While targets have been useful in the UK system, it has been acknowledged that they have their limitations, largely because they are narrowly based and this distorts provision away from non-targeted services, which in turn leads to over-complex bureaucratic processes to try and counter balance this effect. The UK Strategy Unit<sup>9</sup> has recently put forward a comprehensive approach to achieve better performance. This includes a systems approach with four dimensions, each

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<sup>9</sup> Announced at a conference entitled “21<sup>st</sup> century Public Services – *Putting People First*” held in June 2006.

of which is intended to help counterbalance the other three dimensions. The four dimensions are:

- more rigorous top down performance management measures
  - the introduction of competition and contestability into the provision of public services
  - greater opportunity for consumer “choice and voice” to shape services
  - strengthening the capability and capacity of civil servants to deliver through a variety of leadership initiatives<sup>10</sup>.
25. What is clear from this and related initiatives is that the UK is moving towards more emphasis on incorporating the perspectives of service users and the public generally in strategy and service design, which includes collecting information about service quality (e.g. fairness, timeliness and accessibility). The UK has also recently announced a partnership model between public, private and third sectors to deliver services in order to be more responsive to the needs of individuals and communities. It is noted that the strong business and other engagement of the UK civil service creates effective external linkages.
26. The review team also explored the concept of public value originally proposed by Harvard Professor Mark Moore<sup>11</sup>, which has permeated the thinking around performance of the State. Public value reflects, in broad terms, the kind of “good government” goals and expectations that are usually established in most Commonwealth countries. In particular the public value concept lies behind much of the UK work on consumer voice and choice.
27. Similarly, Canada has introduced a strong citizens focus to their public service as part of a results package. Interestingly, Canada has demonstrated through empirical evidence that customer/client success is directly related to employee job satisfaction. Canada is also moving towards more rigorous performance measurement<sup>12</sup>.
28. Experience in other countries, notably the UK and Singapore, shows that development of a capability to integrate long term thinking into policy and service delivery is an important part of learning and innovation. There are different ways to develop the capability for this. In the UK, the Strategy Unit has experimented with two approaches: a central pool of futures practitioners within the Unit and embedding practitioners in a variety of other agencies. In Singapore, futures’ thinking has become so integral to the way in which the business of government is conducted that single agencies are required to take a 1-20 years perspective in their planning and the centrally located Scenarios Unit takes a 20-50 year perspective.
29. A challenge for the New Zealand Office of the Auditor-General is to contribute to the better performance of the New Zealand Public Sector without undermining the independence of the Auditor-General. This includes bringing to attention observed good practice that is relevant from national and international experience in either or both the public and private sectors. The relevance and applicability of such good practice depends to a considerable extent on the Office’s knowledge and understanding of the issues and the public sector environment.

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<sup>10</sup> Details can be found on: [www.strategy.gov.uk](http://www.strategy.gov.uk)

<sup>11</sup> Mark H. Moore (1995) *Creating Public Value: Strategic Management in Government*, Harvard University Press

<sup>12</sup> This approach is set out in *Management Accountability Framework* developed by The Treasury Board of Canada Secretariat. Details can be found at <http://www.tbs-sct.gc.ca>

## **DOCUMENTS EXAMINED**

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2. “Peer Review of the New Zealand Audit Office”, Australasian Council of Auditors General. Wellington. August, 2001.
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  - Meeting: 10 September 2004
  - Meeting: 28 February 2005
  - Meeting: 11 April 2005
  - Meeting: 2 December 2005
  - Meeting: 15 February 2006
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  - What is an Audit (Page 10)
  - Independence Rules (Page 12)
  - Financial Report Audit (Section 15)
  - Performance Audit (Section 16)
  - Other Services (auditing of an assurance nature) (Section 17)
  - Inquiry (on request or own (Auditor-General’s) initiative) (Section 18)
  - Applying four principles to work (Page 15)
  - Quality Assurance (Page 16)
  - Selecting Performance Reports (Page 18)
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  - (f) Review of support for study leave
  - (g) Review of Payroll controls
  - (h) Review of controls over Security Clearance
  - (i) Independence Declarations
  - (j) Review of controls over Leave Management
  - (k) Review of Health and Safety policies
  - (l) Mobile Phone usage
  - (m) Internet, email and telephone usage
  - (n) Credit card usage
  - (o) Review of mobile computer security
  - (p) Taxi usage
  - (q) Review of Legislative Compliance procedures
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82. Quality Assurance process for annual audits
83. Copy of report to the Leadership team that sets out the quality assurance planning programme for the year ended 30 June 2007
84. Copy of report to the Leadership team that provides an update on the quality assurance review programme for the 9 month period from 1 July 2006 to 31 March 2007
85. File review checklist (for audits other than schools)
86. School audit checklist
87. Example of QA letter to a school auditor
88. Example of a QA letter for the review of audit files other than school audits

89. Copy of letter to all appointed auditors (other than school audits) reporting common findings on quality assurance reviews for the 2005/2006 year
90. Copy of letter to all appointed auditors of schools reporting common findings for the 2005/2006 year
91. Copies of reports on the quality assurance reviews conducted on the products of the Office, other than annual audits:
  - (a) Quality assurance review of the processes underlying the Office of the Auditor-General's role in respect of its statutory functions under the Local Authorities (Members' Interests) Act 1968
  - (b) Quality assurance review of the processes underlying the Office of the Auditor-General's briefings and advice to Select Committees on financial reviews and estimate examinations
  - (c) Quality assurance review of the processes underlying the Office of the Auditor-General's performance audit reports
  - (d) Quality assurance review of LTCCP audits
  - (e) Quality assurance review of the processes underlying the Appropriation Audit and the Controller Function
  - (f) Quality assurance review of the processes underlying the Inquiry function
  - (g) Quality assurance review of the processes underlying other assurance services provided under S17
  - (h) Quality assurance review of the processes underlying B29 reports to Parliament
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95. Spreadsheet of 2006 Auditors – basic information
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97. School Audits 2006 – Index of Reference Material
98. Schools Annual Audit Brief – 2007
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