

Local Government Internal Audit Compliance

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ABSTRACT

Local Government Councils are reliant on a number of funding sources including State and Federal governments as well as their community constituents to enable them to provide a range of public services. Given these funding sources councils need to have in place a range of strategies and policies capable of providing good governance and appropriately discharge their financial accountabilities. To assist Local Government Councils with meeting their governance and accountability obligations they often rely on guidance from their key stakeholders. For example in the Australian State of NSW, the Office of Local Government has developed a set of guidelines, the Internal Audit Guidelines. In 2010 the NSW Office of Local Government issued revised guidelines outlining that an internal audit committee is an essential component of good governance. In addition, the guidelines explained that to improve the governance and accountability of the councils, these committees should be composed of a majority of independent members and to maintain committee independence the Mayor should not be a member of the committee. However these are only guidelines, not legislated requirements and as such compliance with the guidelines, before they were revised, has been demonstrated to be quite low (Jones and Bowrey, 2013). This study, based on a review of NSW Local Government Councils' 2012/2013 reports, including Annual Reports and associated disclosures, assesses the level of compliance with the 2010 revised guidelines, specifically in relation to internal audit committees, to determine if the guidelines are sufficient to improve Local Government Council governance.

INTRODUCTION

Local councils in Australia were initially established to provide basic public services such as road maintenance, waste removal and water supply to their communities. Over time the councils have evolved to be responsible for providing an increasingly wider range of community services including aged and health care. Local councils have limited capacity to generate revenue and in order to be able to provide an ever increasing range of services they rely on funds generated through rates as well as grants from both State and Federal governments. As trustees of a large quantity of public assets and public funds councils are accountable for their actions to the community and governments who fund their activities. One key governance mechanism implemented to increase the accountability of councils is the provision of an internal audit function, with an independent audit committee. Guidelines for the establishment of the internal audit committee within councils were issued in 2010 (DLG 2010b) and prior research (Jones and Bowrey, 2013) demonstrated that initially there was low

level of compliance by councils with these guidelines. This paper explores the subsequent compliance with these guidelines and encompasses a review the recommendations from the Local Government Review Panel (Sansom *et al*, 2013) on how to enhance accountability and governance with Local Councils.

LOCAL COUNCIL BACKGROUND

Local government in Australia was first established in the early 1800s with the country being divided into counties and parishes along the lines of the British model. However due to the fact that the sparsely populated new continent could not be compared to the densely packed villages of England, did not work very well (NSWEdu, 2002; Parliament of New South Wales, 2014). After Federation in 1901, legislation was introduced by the various State Governments to consolidate the differing forms of local Government which had developed. It was at this time that Australian Local Councils were conceived “as a tool with which to provide basic property services” (Warburton and Baker, 2005, p. 62) to the community living within the local area. Similarly, to the Federal model, Local Governments in NSW were initially established by the NSW State Government as a mechanism for requiring local communities to provide their own local services and reducing State Government duties by delegating them to the local authorities. From the time of the initial white settlement of NSW the Governor had complete authority over all governmental responsibilities, including local government. Subordinate to the Governor were a number of military commanders or civil magistrates who were charged, by the governor, with carrying out the governmental responsibilities. As the early colonial government was unable to provide adequate services to all the local areas, due to a lack of available funds and resources, the opportunity arose for the creation of municipal institutions to carry out some of these duties (NSWEdu, 2002).

The Australian political arena operates under a government system with three distinct levels, consisting of Federal (Commonwealth) Government, State Government and Local Government (Boon *et al*, 2005). The Federal Government oversees a federation consisting of six states and two territories which have been granted authority to operate under the Commonwealth Constitution Act 1900 (Burritt and Welch, 1997). There are however a number of inequities between Federal and State governments which are principally due to their differing capacities to raise revenue and therefore finance their expenditure commitments (Stilwell and Troy 2000). The Federal Government is able to implement and control many expenditure policies by virtue of controlling the bulk of tax revenues granted under the *Commonwealth Constitution Act 1900*, thereby providing the federal government with the power and capacity to exercise a large amount of control over both state and local government expenditure. The Federal Government collects approximately 76% of the nation’s tax revenue, the State’s 20% and Local Councils 4%, which demonstrates the imbalance of income taxing powers (Stilwell and Troy, 2000, p. 115).

Local councils manage public monies and assets (*NSW Trustees Act 1925*) and accordingly they have a fiduciary responsibility to protect these assets as well as to manage those funds for the benefit of stakeholders. However as the Federal and State Governments possess most of the revenue raising powers Local Governments are heavily reliant on both for funding via Operating and Capital Grants. The funding from the Federal and State Governments is shown in Table 1 which presents the total value of grants provided to NSW Local Government Councils for the financial years 2011/12 and 2012/13. Table 2 highlights the reliance on these funds by comparing the total operating profit of these councils when the operating grants are included and excluded.

Table 1: Total Value of Grants Provided to NSW Local Government Councils, 2011/12 and 2012/13

Operating Grants (000s)		Capital Grants (000s)	
2013	2012	2013	2012
1,550,000	1,690,000	1,430,000	1,220,000

Table 2: Total Operating Profit of NSW Local Government Councils Including and Excluding Operating Grants, 2011/12 and 2012/13

Total Operating Profit (\$000s)		Operating Profit Excluding Operating Grants (000s)	
2013	2012	2013	2012
1,150,000	1,150,000	(400,000)	(541,000)

Even though these funds, which are public funds, are generally provided as grants there has only ever been “low levels of accountability and very little performance measurement taking place” (Kloot 1999, p. 571). This has contributed to the Local Councils being perceived as inefficient, and unable to manage the commercial elements of their operations (Barrett, 2002) and proposals have been made that Local Councils should adopt a more business style approach to the management of the local government sector (Hood and Peters, 2004; Modell, 2005; Skalen, 2004; Worthington and Dollery, 2002). Community concerns, which have been continually raised, have encompassed disquiet about the quality and comparability of public sector external reports, while also raising questions about both the efficiency, and the effectiveness of public sector management (*Corporations Act 2001*; Barton, 1999; Hoque, 2004 and 2005). Additionally, one of the major concerns is that Local Governments, because of the level of trust placed in them, are seen to not be appropriately accountable for the funds under their management.

Consequently, the minimal levels of accountability have resulted in demands for additional information on how governments manage and spend public funds (Kent, 2003, p. 11). By the late 1970s, due to the absence of specific standards for the public sector, the Commonwealth and State Auditors-Generals began to apply private sector standards to the public sector (Chua and Sinclair, 1994, p. 690). However, the accounting profession was not unanimous on the applicability of private sector standards being applied to public sector financial reports (idem, p. 689) and suggested that there was not a “one size fits all” standard solution when comparing public and private entities, and that private sector practices and standards may be inappropriate to use in the public-sector (Barton, 2005; Carnegie, 2005; Carnegie and West, 2005).

GOVERNANCE AND ACCOUNTABILITY

There are a variety of definitions of what good corporate governance entails. In Australia, while technically the system of corporate law is state based, in practice the primary legislation is the *Corporations Act 2001*, as the states all provide reference to the Federal Act within their

own legislation (Hill, 2010, p. 1). In recent times the Commonwealth government has increased the focus on corporate governance (Bowrey, 2008) as a means of increasing assurance and demonstrating adequate oversight of government bodies. From the perspective of the Commonwealth, corporate governance refers to (ANAO 2003a, p. 6):

... the processes by which organisations are directed, controlled and held to account. It encompasses attributes authority, accountability, stewardship, leadership, direction and control exercised in the organisation.

While the attention of corporate governance has been primarily on private sector organisations, it is equally important for public sector organisations to have strong corporate governance structures. Public bodies are responsible for the management and administration of public funds and are therefore expected to have good corporate governance systems in place (ANAO, 2003a; APSC, 2005 and 2007). Edwards (2002) acknowledged that the corporate governance structures in both the public and private sectors have areas of commonality particularly in relation to performance and the roles and responsibilities of their governing boards and executive officers. This has led to a significant push for the public sector to adopt private sector corporate governance processes and structures. In the public sector the increased focus on performance and responsibilities is consistent with the move to “new managerialism” in the public sector (Jackson and Lapsley, 2003, p. 360) and the perceived need of the “public sector to improve its efficiency, effectiveness and accountability” (Barton, 2005, p. 138; Guthrie, 1998, p. 2).

Similarly, Uhrig (2003, p. 2) described corporate governance as “the power of those in control of the strategy and direction of an entity ... taking into account risk and the environment in which it is operating”. Barrett (2002, p. 8) proposed that the generally accepted meaning of corporate governance encompasses “how an organisation is managed, its corporate and other structures, its culture, its policies and strategies, and the ways in which it deals with its various stakeholders”. Likewise, Edwards (2002, p. 51-52) described governance as “dealing with all forms of the organisational relationships”, and that good governance is able to “assist performance, provide accountability, transparency, participation and efficiency”. She also highlighted that the introduction of private sector practices into the public sector has created the assumption that the corporate (private) form of governance can be readily adapted to the public sector. The focus in recent times on corporate governance has been mainly on the impact of poor corporate governance, which has led to the collapse of a number of organisations (Allan, 2006; Mak *et al*, 2005; Parker, 2005). These events have led to increased interest in “regulatory and other responses to improving corporate governance in the private sector” (ANAO, 2003b, p.6).

While the emphasis of public sector reforms has been on the financial and budgetary measures for financial accountability, the performance of both programs and people are both being measured. The expanding regulation of LGAs has continued to increase the need for disclosure in a wide range of areas so that the actions of LGAs can be scrutinised and allow them to be held to account for those actions (Gray, 2001). These regulations and reliance on funding from state and federal governments impose duties on LGAs to be accountable and provide reports and information to meet both the regulatory requirements of state and federal governments, and to address the needs of a variety of other stakeholders. Accountability is seen as an essential component of good management and practice, particularly as LGAs have the responsibility and duty of managing public money. This has been demonstrated by the requirement of the *NSW Trustees Act 1925* which highlighted that LGAs, as managers of public funds, have a fiduciary responsibility to both protect public money and assets, and to ensure that they manage those funds for the benefit of all their stakeholders.

Much like corporate governance accountability is a broad concept to with a variety of understandings (Bovens, 2007b; Carnegie, 2005; Carnegie and West, 2005; Trippett and Kluvers, 2010) with the general consensus being that in order to be accountable; an essential requirement ought to be that one party must be obliged to provide a full account of events to another party, with an obligation to both “explain and justify his or her conduct” (Bovens, 2007a, p. 447). Within the Local Council context, councils are required to provide a variety of reports and accounts to the State government (via the NSW Office of Local Government), yet does that make them accountable? The providing of information may be an essential component of accountability (ASIC, 2001; Funnell, 1998 and 2003; Funnell *et al*, 2009) however the availability of additional information does not automatically lead to greater accountability (Broadbent and Laughlin, 2003). Accountability requires openness, transparency, that there is someone to whom you are required to report, and that there are consequences for inappropriate actions (Barton, 2005).

One factor highlighted by Brown (2011), was that insufficient controls, such as failure to have an internal audit function, has meant that councillors have had to rely on reports provided from the general manager or other council staff. This has raised concerns about governance weakness within the Local Councils, as there is no check or mechanism in place to confirm the validity of information and reports provided. Gold (2008, p. 51) has proposed that Local Council governance was inadequate, and that stakeholders are being exposed to “imprudent investment decisions and economically sub-optimal outcomes”. Even before the Global Financial Crisis and the subsequent credit market crash was apparent, the NSW Department of Local Government was providing information to Local Councils reminding them of their fiduciary duties and responsibilities in respect to financial investments. This communication highlighted to Local Councils that their responsibility was to ensure that investments were made in accordance with the Act with the “onus for investments ... to be on preservation of capital rather than the rate of return” (DLG, 2006, p. 36).

INTERNAL AUDIT FUNCTION AND AUDIT COMMITTEES

Internal auditing is used as a tool to monitor and improve the effectiveness of internal controls within organisations. The primary concerns of internal auditors are to identify areas of risk and determine methods of controlling and minimising those risks. Sound and reliable internal auditing provides a strong mechanism to contribute to the governance and accountability requirements of Local Councils (DLG, 2008) through an independent internal audit committee which in turn contributes to providing objective assurance that the accountability requirements of the NSW State Parliament (Sendt, 2002) have been addressed.

The 2010 Internal Audit Guidelines issued by the DLG outlined a range of accountability and governance requirements. These included recommendations that the internal audit function needed to be independent both in fact and in perception. The primary device to achieve this was through establishing an internal audit committee. The function of the internal audit committee in local councils is to support and oversee the direction of the internal audit activities, to provide independent oversight and separation from management and councillors. However, while these requirements were provided as mechanisms for ensuring good governance and accountability, they were only “strong recommendations” (DLG, 2010b) and there was no capacity nor requirement of the DLG to enforce Local Councils to comply. Sterck and Bouckaert (2006) concluded in their study of audit trends in the public sector that regulatory mandated internal audit functions enhanced corporate governance. Prior research (Jones and Bowrey, 2013) showed that the level of compliance with the requirements to have an internal audit function, an independent audit committee and for the mayor of the council to be excluded from that committee was low. This research demonstrated that only one third of

councils had an internal audit function. This indicated that non-mandated requirements for an audit committee are insufficient instruments to ensure that councils will comply.

The report of the NSW Independent Local Government Review Panel (Sansom *et al*, 2013) indicated that only about half of NSW had any sort of internal audit function and that they tended to focus on compliance, risk and fraud control, while many of those councils that do have internal audit functions are “strongly embedded within the councils and report directly to the General Manager” (Sansom *et al*, 2013, p. 56). This diminishes the capacity of the internal audit function to work and can generate conflicts of interest. Reporting to the General Manager rather than to an independent committee may create circumstances where general Manager may limit or even conceal adverse internal audit reports. An analysis of the NSW local councils’ Statements of Financial Performance for the 2012/13 financial year has shown that only 31 of 150 councils have recorded any expense in relation to internal auditing. The average amount recorded as an internal audit expense in 2013 was only \$31,380 and in 2012 was \$30,710, which is not enough even for one full time internal audit position. One reason for the low expenditure may be that councils contract out the internal audit function to external providers and limit the amount of work they conduct. However, this does suggest that many NSW Local Councils underfund the internal audit function and that there is a perception that the roles undertaken by internal auditor are non-essential.

The NSW Independent Local Government Review (Sansom *et al*, 2013, pp. 56-57) has provided a number of recommendations to revitalise NSW Local Government. In relation to internal auditing these include requiring:

- Extending the concept of internal audit to include adding value and continuous improvement
- ALL councils to have effective internal audit processes
- Internal audit committees with a majority of independent members, an independent chair and preclude the General Manager from membership
- Requiring the chair of the internal audit committee to report at least biannually to a council meeting on financial management, good governance and continuous improvement
- Empowering the Auditor-General to conduct issue-based performance audits in key areas

Suggestions also include presentation and tabling of internal audit information at a public presentation such as the council meetings or annual meeting. All of these recommendations are aimed at providing higher levels of governance and accountability by Local Councils.

CONCLUSION

NSW Local Councils have been provided with a range of recommendations to enhance and improve governance and accountability within the sector. These recommendations have been strongly recommended but have not been made compulsory and have lacked legislative authority to enforce compliance. Even when the DLG required the public release of financial reports (enforceable) (DLG, 2009; DLG, 2010a), this research has demonstrated that there was still not 100% compliance. The NSW Independent Local Government Review (Sansom *et al*, 2013) suggests that it should be compulsory for Local councils to have internal audits and independent audit committees. It appears clear that without legislative force Local Councils will continue to ignore the recommendations and fail to provide adequate levels of governance and accountability.

As trustees of public funds Local Councils have a responsibility to manage them prudently and protect the interests of the community. Safe guards such as an internal audit committee which is overseen by an audit committee, where the majority of members are independent and where the management of councils does not have a role, are essential for providing good governance and accountability. The current position is that many councils do not have an internal audit function at all and where they do have an internal audit function the majority of the internal auditors report to the council general manager. This is a clear problem as there is no separation of roles and there is no capacity to report problems that may have emanated from the general manager or that the general manager may wish to avoid scrutiny over. Therefore there are insufficient mechanisms for independent review and scrutiny. The recommendations from the NSW Independent Local Government Review (Sansom *et al*, 2013) will provide a framework for greater accountability and governance however they need to have legislative powers to enforce compliance and clearly defined penalties for non-compliance as has been demonstrated some Local Councils will need to be compelled to comply.

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