

# VERIFIED TRANSCRIPT

## PUBLIC ACCOUNTS AND ESTIMATES COMMITTEE

### Inquiry into Victoria's Audit Act 1994

Melbourne—29 April 2010

#### Members

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Ms J. Huppert

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#### Witnesses

Dr G. Pflugrath CPA, Policy Adviser, CPA Australia, and

Mr A. Stringer, Head of Audit, Institute of Chartered Accountants.

**The CHAIR**—I declare open the Public Accounts and Estimates Committee hearing on the inquiry into Victoria's Audit Act 1994 and on behalf of the committee I welcome Dr Gary Pflugrath CPA, policy adviser, CPA Australia.

**Dr PFLUGRATH**—Thank you.

**The CHAIR**—And also Mr Andrew Stringer, head of audit, Institute of Chartered Accountants. Members of the public and the media are also welcome.

In accordance with the guidelines for public hearings, I remind members of the public that they cannot participate in the committee's proceedings. Only officers of the PAEC secretariat are to approach PAEC members. Officers, as requested by the witnesses, can approach the table during the hearing. Members of the media are also requested to observe the guidelines for filming or recording proceedings as they would if in the Legislative Council committee room.

All evidence taken by this committee is taken under the provisions of the Parliamentary Committees Act and is protected from judicial review. However, any comment you make outside the precincts of the hearing are not protected by parliamentary privilege. There is no need for evidence to be sworn. All evidence given today is being recorded. Witnesses will be provided with proof versions of the transcript to be verified and returned within two working days of receiving the transcript. In accordance with past practice, the transcripts and any PowerPoint presentations will then be placed on the committee's website.

I now pass to Dr Pflugrath and Mr Stringer for any opening comments. Of course, committee members will ask questions relating to the review of the Audit Act and, generally, we will take it in a little bit of order when we ask the questions. I ask that mobile telephones be turned off. Thank you. And I thank you very much for your submission and interest in our very important inquiry.

**Dr PFLUGRATH**—Thank you very much. I will start off with an opening comment.

**The CHAIR**—Sure.

**Dr PFLUGRATH**—First of all, thank you very much to the committee for inviting us along to give our views on our submission to your inquiry into the Audit Act. I should probably explain to you the way in which we do our joint submissions. I find that sometimes people do not appreciate what they often see as being a competitive arrangement, where we have three professional accounting bodies in Australia. On most areas of public interest in the policy, standard-setting, regulatory environment, we do joint submissions. The three bodies—CPA Australia, the Institute of Chartered Accountants and the National Institute of Accountants—submit jointly and together we represent over 180,000 professional accountants throughout Australia and overseas. So, typically, we would do joint submissions, as we have done today. I would like to refer to our submission and note that we have not covered all aspects of the discussion paper.

**The CHAIR**—We can ask a lot of questions.

**Dr PFLUGRATH**—Yes. Clearly, we see that a lot of them are outside of the area of interest or the purview of the professional accounting bodies, so we have restricted our comments to what we see as areas of interest for the accounting and auditing profession and today, again, we would restrict our comments to those particular areas.

I think it is important to point out that within Australia we have what we consider to be quite robust auditing and assurance arrangements—a framework and arrangements for audit that

has served Australia particularly well, I believe. A critical aspect of that is the need for assurance practitioners to adhere to relevant ethical requirements. For the accounting profession, these requirements are embodied in our code of ethics for our profession, requiring the need to adhere to principles such as integrity, objectivity, professional behaviour and due care, and—particularly when you look at the audit and assurance area—independence is vital. Independence is the cornerstone of audit and assurance; therefore, we do make the point that the independence of an auditor-general and public sector auditing is critical, as well as being an important part of the provision of audit services.

Another important aspect of the framework and arrangements is the Auditing and Assurance Standards. Australia is one of the few countries in the world that does have legally enforceable auditing standards for audits done under the Corporations Act and, as a consequence, of course, have a government body established as a standard setter, establishing audit and assurance standards. That, of course, is the Auditing and Assurance Standards Board.

**The CHAIR**—I used to be on the advisory committee for that one, but I have never received an invitation to it.

**Dr PFLUGRATH**—Really? The pronouncements that they have issued in Australia, which are based on international high-quality, best practice pronouncements, have been promulgated with thought being given to the public sector. There are, for example, paragraphs included in our standards that refer to public sector auditing if you are an auditor-general within Australia. I should have mentioned that the code of ethics for professional accountants also has specific paragraphs within it relating to public sector auditing. In fact, in Australia we have a specific assurance pronouncement called 'performance engagements', which was specifically developed with the public sector in mind. With that in mind, our view from the accounting profession is that we see that those ethical requirements and those audit and assurance pronouncements should underpin all of the audit and assurance work that is done within Australia.

The final comment I would like to make in our opening statement is that, in preparing our submission—in preparing all submissions, I think it is true to say—we take very much a public interest perspective. It is not always the perspective that all of our members agree with; they think that we should take a different view on certain things. But we see what is best for the accounting profession as being paramount, and what is best for the public. So certainly in this area, where taxpayers' money is involved, where we see there being a high level of public interest and the need for public accountability to be paramount, our submission and the views that we have formed have been viewed in that context.

**The CHAIR**—I appreciate that very much. There are a range of things we want to discuss with you today in the short time that we have with you. I might just work down the list that you gave us. Is that the easiest way, do you think?

**Dr PFLUGRATH**—Yes.

**The CHAIR**—And I know there have been issues in other jurisdictions as well. We did talk to the Canadians when we were doing a review of the Financial Management Act and there were issues in Canada regarding the Auditor-General and the Auditor-General's following of audit standards, and there was public discussion and also discussion within the accounting profession in that regard. We will come back to that as we go through; this comes in later on.

But just starting off on chapter 3, regarding the relationship with parliament, in section 3.2.7, 'Consultation by the Auditor-General with the committee on performance audit

specifications', the Auditor-General is proposing removing the act's requirement to consult with the committee on performance audit specifications. You have given the impression that you do not see any need for that to continue, whereas in the committee I think we have generally found there is, particularly amongst those members of the Audit Subcommittee, a reasonably productive discussion in order to frame the specifications for the audit.

**Mr STRINGER**—If I could perhaps add something in there. What Gary has alluded to is the existence of our auditing national standards setter, which is a federally funded statutory authority, the Auditing and Assurance Standards Board, which sets world best practice auditing standards, included in which is the performance engagements standard. Our view is that having as a baseline the standards that are enacted or promulgated by that body is, for us, the starting point. By all means, if you wish to add to any of the requirements therein, that is fine, but as a fundamental base our strong view would be that the standards set by the Auditing and Assurance Standards Board would be the ones that are front and centre.

**The CHAIR**—That is fair enough. I think it is not a matter of the parliament seeking to set additional standards. It is the parliament seeking for this particular Public Accounts and Estimates Committee to have a close relationship with the Auditor-General without derogating from the independence of the Auditor-General; to provide our comment for the Auditor-General to consider in order to—and the intention is to—improve, and some of the discussions have moved that particular way, because often there is a breadth of experience and capacity which can be quite different, necessarily, in the Auditor-General's Office.

**Dr PFLUGRATH**—Yes. I do not believe we were suggesting necessarily that discussions would not continue, but we were stressing the need for the Auditor-General to ensure that they are independent. That was the focus in our submission: that it is important that the relationship does not impair that independence. That is, I think, the point we were stressing there.

**The CHAIR**—All right. Good. Gordon, do you want to bring something up?

**Mr RICH-PHILLIPS**—Yes, a couple of matters. I will start on the chapter 5 section in relation to access to the private sector. Can I take it from your submission that you see that particular issue best addressed through a contractual arrangement between government and the particular private partner in a particular matter, rather than through legislation?

**Mr STRINGER**—The view that we took is that, in any arrangements between the private sector and the government, the first point of call could and should be what is written into the contract, so the accountability aspects of that get written into the contract itself and you have some fairly rigorous safeguards around that. You have actually got two aspects to this.

You have got the strict accountability framework, so you would be looking for assurance around the money that you are granting: 'Is the other party acting in accordance with the arrangements that I'm making?' The second thing is then what I call the performance engagements side of it, which is looking at the economy, effectiveness and efficiency of what has been done. That first question is: has the other party done what they said they were going to do? Then the next question, which I think is a valid one for the Auditor-General to be asking, is: has that been done effectively, efficiently and economically? We do make the point that it is the exception rather than the rule and there should be appropriate safeguards.

**Mr RICH-PHILLIPS**—I guess the issue I am raising is: your starting point is, if I interpret correctly, a belief that the two parties to the contract, the government and the private sector party, will want a contract that puts in place those disclosure mechanisms.

**Mr STRINGER**—Yes.

**Mr RICH-PHILLIPS**—And perhaps as a parliament we might take a more cynical view and say that it may not be the government's intent to have those mechanisms in place in a contractual relationship; therefore, should there be an overriding provision in the audit legislation that, notwithstanding what may or may not be in a contract, the Auditor-General can go in and examine those arrangements and follow the money trail?

**Dr PFLUGRATH**—I think you have summarised our view, yes, except that you called it a disclosure arrangement and I would call it, say, an accountability arrangement. To go back to what Andrew was saying, the accountability side—which typically is done through an acquittal process or an audit of financial statements, something to that effect—can generally be satisfactorily done by the external auditor of that private body furnishing an audit report back to the contracting agency, for example. Similarly, in the performance auditing space you could have—

**Mr RICH-PHILLIPS**—Could I just stop you there. On that point, yes, a report could go back to the contracting agency, but that does not equal reporting back to parliament as to the expenditure of public money. So, yes, there can be reporting arrangements between the contractor and the government, but that is not the same as public reporting back to parliament through the audit mechanism.

**Dr PFLUGRATH**—But I would see then that there would be an aspect of the Auditor-General reviewing that contracting agency to make sure that they had received that accountability feedback—I do not know what to call it; I have called it accountability feedback—that is in place when they do audits of the contracting agency. As Andrew said, we see that, if something is written in as an exception rather than a rule, an Auditor-General doing an audit of that contracting agency would be seeking to see that those accountability measures are in place, and if there are issues of concern or the accountability measures are not in place, then there should be a provision for them then to—

**Ms HUPPERT**—I guess my concern—and this has come from somebody who until quite recently, whilst not in parliament, was a lawyer involved in negotiating contracts on behalf of the government—is that very often there were confidentiality provisions in those contracts, and the exemption was material already in the public eye or material that is required to be disclosed by law.

I think my concern is more that, from a negotiation point of view, the standard starting point, from a lot of contractors, is, 'We'll put our standard confidentiality provision in there.' So the view that we are concerned about is that, unless there is something backing it up—the reason why this has arisen is reports from various agencies and some of our experiences in relation to contract negotiation. That is why we are seeking the views of other parties about putting a provision in legislation that would then allow the release of those documents to the Auditor-General and other appropriate—

**Mr STRINGER**—Would you not see as the mechanism by which this works that, if you do have provisions in a contract that require the contracting agency and the other party to have that reporting-back, the reporting-back goes back to your contracting agency and then the Auditor-General would have access to that accountability mechanism, and then if there happens to be something untoward that appears to be there—

**Ms HUPPERT**—If that was in a standard contract, the Auditor-General's comment has been that on occasion they have been unable to find documentation within the government agency that allows them to determine whether or not government funds, public funds, have been appropriately expended. They have been stymied because they have been

unable to follow that money into the private contractor's hands.

**Dr PFLUGRATH**—That would be one of those exceptions where, if the act allowed them access, they would follow that through.

**The CHAIR**—Talking about safeguards, wouldn't the very idea of having to receive permission before access be completely derogating from the independence of the Auditor-General?

**Dr PFLUGRATH**—Receiving permission from?

**The CHAIR**—You have suggested, in terms of safeguards, including 'provisions in contracts, receiving permission before access'. I would have thought that the Auditor-General having to receive permission before he accessed documents would be flying in the face of the independence of the Auditor-General—and flying in the face of the parliament, because the Auditor-General in our view is an officer of the parliament.

**Mr STRINGER**—Yes, that is a fair point.

**Dr PFLUGRATH**—It is, yes.

**The CHAIR**—We are just trying to understand.

**Dr PFLUGRATH**—Yes.

**The CHAIR**—And we are thinking ahead to what can we say in our report in terms of advice on how we might frame a new act, and if the new act says the Auditor-General can follow the money, but that is the exception rather than the rule and there have to be safeguards, I know what the Auditor-General is going to say to us.

**Dr PFLUGRATH**—I must admit, reading that again, 'receiving permission'—Andrew, correct me if you have a different view on this—I believe that the point we were trying to make was that it cannot be what you might call a flying squad type thing; the Auditor-General cannot just come in and swoop, necessarily; that they have to advise that they are coming in to do it because there is an issue.

**The CHAIR**—So that they can prepare beforehand and cover up?

**Mr RICH-PHILLIPS**—It is probably unfair, but I would be interested in the answer.

**Dr PFLUGRATH**—Hopefully, the period of time between when the advice is given that they are coming and when they do arrive would not allow for a cover-up.

**The CHAIR**—It is a fair issue. I was on the Law Reform Committee several years ago and we did a review of entry, search and seizure. We came up with a new framework for dealing with this matter, and there were certain ones, we discovered, where people were given lots of advice and some where someone could just come along. In some cases they had to get a warrant from the court. In all cases they had to be clearly authorised and they had to show their identification. In certain areas, obviously, they could not be refused, and some of them of course brought the police with them, but that is probably a bit extreme. But there is a whole range, as you can imagine, from Fisheries officers who possibly are in danger of being shot by poachers, to somebody just checking out the local chemist, which is quite different. But it is a matter of trying to frame these things, I think.

**Mr RICH-PHILLIPS**—Could I just finish on this point?

**The CHAIR**—Follow that through. Yes, please.

**Mr RICH-PHILLIPS**—I also understand, from what you are saying about the Auditor-General following the money trail into the private sector, that it is your view that the Auditor-General should accept, in the first instance, audit work that has been performed for those private sector companies as conclusive proof of whatever the circumstances are, rather than undertaking a primary audit of that money trail.

**Mr STRINGER**—In the first instance, yes, I would say so. The proviso would be if there are indications, perhaps arising out of the contracting agency or from other sources, that all is not what it seems. Then by all means have some mechanism by which the Auditor-General can then go in. But in the first instance, yes.

**Ms HUPPERT**—I think that is fairly standard, though, and the way they operate.

**The CHAIR**—It is standard, but typically they would be dealing with the agency which is the supervising agency for the contractor, and the relationship between the agency and the contractor, and looking for what that might mean. But there are a whole lot of other things out there in terms of performance of the contractor, aren't there?

**Mr RICH-PHILLIPS**—I do not think there is a lot of precedent for the A-G's Office relying on a third party audit as conclusive proof. Their work is primary audit work.

**Ms HUPPERT**—An issue is that what the Auditor-General is actually auditing in their performance audit is the contract management side of things. It is not how the contractor is actually performing but how the agency is managing that contract, including what is happening with the public funds that have been expended by that agency.

**The CHAIR**—I think there are a few moot points in that one, myself.

**Ms HUPPERT**—But that is the issue, isn't it? The question is, if that sort of power is given to the Auditor-General, the extent of that power and what they are doing.

**The CHAIR**—We are emphasising these days outcomes and performance, rather than simply whether the money has been transferred from one bank account to another, so there has to be a performance measurement. Obviously, they would be looking at the performance reports that people have done, but they would also want to have the capacity, as the Auditor-General does, to test some of these.

**Dr PFLUGRATH**—But going back to the point about the first-stage accountability, there would be no reason why a third party external assurance practitioner could not provide assurance over those performance reports that were being prepared, either by the private contractor back to the agency or as the agency has required from them.

**The CHAIR**—That is true, but it is not always as simple as that. It is not necessarily exactly the same thing, but we have had occasions in our committee where we have had probity arrangements which have been organised through boards of government corporations, where they just had two members of the board, and they are following different procedures because their incorporation, even though they are government corporations, is through a government department. We have made it very clear that this sort of procedure is not good enough and we have said they should be following the same procedures as government departments in order to ensure appropriate standards of probity in the conduct of tendering. So it is not always the case that you can simply accept what might be done in a corporation.

In this case we are looking at private corporations as being of a sufficiently robust standard. You may disagree with that, are you saying, if they are accountants and they are following the ethics and the guidelines of the profession?

**Dr PFLUGRATH**—What I was saying is that it is not so much the performance reports that are provided by that body; it is the fact that you have a third party independent assurer coming in to provide assurance over the report. That is the point I was trying to make. So that could be the first line, if you like: that you get a qualified assurance practitioner to provide assurance and then that is provided.

**The CHAIR**—Which is similar to what we were doing in the other ones. We wanted to make sure that there was an appropriate probity system of a high enough level of assurance, which is pretty much what we followed in that report in regard to the myki arrangements, which we followed through in subsequent reports.

**Mr SCOTT**—Just to go to the comments on chapter 4, 'Audits of non-judicial functions within Victoria's courts'. You are supporting the audits by the Auditor-General of non-judicial functions of courts, with a number of safeguards relating to the separation of powers, the existence of identifiable separate non-judicial functions and clearly defined responsibilities and scope. Would you see those audits being given the backing of statute, which the Auditor-General wants, rather than just being by invitation? Secondly, regardless of how, who would you see determining issues such as what is a judicial function and what is a non-judicial function? Would you see that being outlined in statute or would you see that being the purview of either the Auditor-General or the courts?

**Mr STRINGER**—Aren't we just dealing with the separation of the administrative function versus the judicial function?

**Mr SCOTT**—But who determines what that is, or how is it determined? It is an issue that we have to deal with, so I am just seeking your opinion on that.

**Mr STRINGER**—To be honest, I have never gone back and thought that that would be very complicated.

**Mr RICH-PHILLIPS**—We didn't either!

**The CHAIR**—There was an issue in 1996 where the opinion from the Solicitor-General made the Auditor-General not table a report on the Children's Court in terms of child protection. It was clearly very much against his will and it was done on the basis of opinion—which I actually have not read myself; I must try and get a copy—that stated that this was attempting to audit the judicial functions rather than the administrative functions. One could express an opinion that anything that a judge is involved in is actually judicial rather than administrative.

**Ms HUPPERT**—That view has been expressed by certain judges.

**Mr SCOTT**—So that is the context in which I ask.

**The CHAIR**—You must face this all the time in the international and national accounting standards, although you are not trying to define things infinitely these days; you are trying to be more outcomes focused.

**Dr PFLUGRATH**—The setting of boundaries is something that maybe in the financial statement audit space is reasonably clear, but once you start getting into areas such as—the best example I can think of—the assurance of greenhouse gas emissions: where is the



boundary of the organisation; where is the boundary of their emissions—it is a very difficult and challenging area that assurance practitioners face. As I say, maybe we were a little naive in expecting that you could easily separate judicial and non-judicial functions of the court. How would you determine that?

**The CHAIR**—I do not know.

**Dr PFLUGRATH**—I am not sure that I could provide an answer to that.

**The CHAIR**—Let's frame it slightly differently. You have mentioned another type of definition, which is between financial and performance. To what extent could an auditor or an auditor-general do performance auditing of courts? If you are doing it of administrative areas where judges may play a role in the management, then you may well be judged to be making judgments on the judicial functions.

**Mr STRINGER**—I can see the dilemma. I would have thought you would not have a problem with following the money, if we are using that analogy; administrative function; accounting for money backwards and forwards; financial statements.

**The CHAIR**—I think that is accepted.

**Mr STRINGER**—But in the performance audit—'Is it being done effectively?'—there can be—

**The CHAIR**—'There is \$400 million spent on the courts. Are they performing effectively?'

**Mr STRINGER**—Yes, I understand. The backlog and all those things. I am not sure I have an answer.

**Mr SCOTT**—I thought it was worth asking.

**The CHAIR**—You said you supported the Auditor-General. But it is a matter, as you put, of clearly defining responsibilities and scope. It is a struggle, I think.

**Ms HUPPERT**—It is an interesting issue.

**Mr SCOTT**—The context in which I was asking it was: if you start to get into issues of where do an auditor's professional obligations start to raise issues about how they are conducting an audit, or conflict with what the judiciary might see as their role and their purview, you start to hit issues where there is conflict between those sorts of ideas and how you determine where those boundaries are. That was really where I was heading.

**Ms HUPPERT**—I want to return to the issue of auditing standards and the view that has been expressed by the Auditor-General that, because of the different context of the public sector environment, there should be some ability to, with appropriate safeguards—possibly through this committee or otherwise through parliament—depart from auditing standards where it could be demonstrated that they just do not apply to the public sector context. I know you mentioned before that you thought that it was appropriate to stick with the current standards and perhaps create different ones, but I wonder if you could expand more, because we have discussed this with a number of other jurisdictions who have varying views on this issue.

**Mr STRINGER**—I thought what we were advocating was to use the existing suite of standards promulgated by the AuASB as the baseline. By all means supplement, but do not

replace. That is what we were suggesting.

**Dr PFLUGRATH**—Yes. Given that the standards are principles based, we would suggest, if there is any supplementation or adding-on done, that it is consistent with the principles that are espoused in those pronouncements as well. The auditing standards board does issue guidance statements from time to time to provide additional guidance in areas. They help explain how you might apply the standards and would probably be the best way to explain that.

**The CHAIR**—I think you are doing some work on those guidance statements, aren't you, for the public sector as well?

**Mr STRINGER**—I am not aware of anything.

**Dr PFLUGRATH**—Not specifically, but there is of course that performance engagements standard that we mentioned which was issued.

**Mr SCOTT**—Only in Australia as far as I know.

**Dr PFLUGRATH**—Yes, it is Australian only. Of course, you are probably aware that there are two auditors-general on the standards board providing input into the development of pronouncements, and were very much playing an important role in development of that assurance standard on performance engagements.

**The CHAIR**—One of the things that we have in the act is that the Auditor-General can undertake financial audits. Indeed, we also appoint an independent financial auditor for the Auditor-General's Office. In fact, we advertised that recently. But the act says that the independent auditor can make, if so required, a report to parliament on the financial audit and, presumably, on the tools that the Auditor-General's Office uses in terms of managing the finances. That is all it says. But the actual way the independent financial audit is conducted is that it is then conducted according to accounting standards, and the big thing in that suddenly becomes this letter, which is not actually in the legislation. The Auditor-General has a discussion then with the independent auditor and obviously it would be in the interests of the Auditor-General's Office not to have a letter about any issues. But it is not required by the act. Should we be specifically saying in the act that this letter be what is required, rather than a special report to parliament?

**Dr PFLUGRATH**—It sounds like a management letter.

**Mr STRINGER**—Can I just clarify the letter?

**Ms HUPPERT**—It was. It was a management letter.

**Mr STRINGER**—So this is the independent auditor of the Audit Office itself?

**The CHAIR**—Correct.

**Mr STRINGER**—Reporting back on the financial statements and then supplemented by what we would call a management letter?

**The CHAIR**—Yes.

**Mr STRINGER**—'Those charged with governance' is where it is directed. Those words are contained and threaded through all the auditing standards. Those charged with governance have ultimate responsibility. Perhaps parliament is 'those charged with

governance' ultimately and that is where the report should go.

**The CHAIR**—What I am saying is: should we be putting in a requirement for a management letter?

**Ms HUPPERT**—That comes to parliament as the entity that is charged—

**The CHAIR**—They are looking at a possible management letter. In fact, a lot of effort goes into make sure that there is not a management letter. That is usual in any organisation. So have we got it right? We are reviewing the act. Should we be saying, 'In accordance with the accounting standards'—it is not a report to parliament but it is a report, including a management letter.

**Mr STRINGER**—Over the years, the development of the auditing standards and the improvement of the auditing standards has changed the focus from the good-old/bad-old days when often the independent external auditor, financial statement auditor, saw their prime responsibility as being to management of the entity and sometimes that then led to this obscuring of the lines, in the private sector, between, 'My ultimate responsibility is to the board of directors, to the owners of the business,' who may or may not be the same as management, or to the trustees, if it happens to be a trust. I have personal experience of a management letter being issued to a company which contained some comments that might have been inferred to be critical of management, of the senior management, expecting that that would go to the board; happening to bump into a board member a few weeks later and saying, 'What was the board's response to that management letter?' and the response was, 'What management letter?' So the management letter had not made its way to those charged with governance.

So the standards now, even though we continue to refer to it as a 'management letter', are really to those charged with governance and, clearly, the independent auditor has an obligation and a responsibility back to those charged with governance. In this instance, it is the determination of who are those charged with governance? Is it not the legislature?

**The CHAIR**—Parliament ultimately is, and obviously this committee is.

**Mr STRINGER**—There is your answer.

**The CHAIR**—What we have done this time in advertising the tender scope document is that, even though it is not in the legislation, the committee has asked that the independent financial auditor provide a report on the way the financial audit has been conducted and any issues which came up. So even though there may not be a management letter, there may well have been discussions of issues and we have asked for that. In fact, we have gone beyond the accounting standards because we did not really know necessarily what might have been happening.

**Dr PFLUGRATH**—I suppose what you are talking about goes beyond what is the typical output of a financial statement audit because the typical output that is provided of course is the audit report which expresses an opinion on the financial statements. In the commercial world, that is the document that becomes public; the management letter does not. As Andrew is suggesting, the management letter is something that is addressed and used by those charged with governance.

**Mr STRINGER**—And really around matters incidental to the audit findings.

**The CHAIR**—The Auditor-General, in the last year or two, has moved into more comprehensive financial auditing arrangements and reporting, which can be seen as a good

thing.

**Mr STRINGER**—It can.

**Ms HUPPERT**—Cross-sectoral comments; in other words, drawing threads from financial audits across particular sectors and producing reports.

**The CHAIR**—And then producing not just financial audits, not just individual performance audits, but sort of cross-sectoral analyses are drawn from the experience in doing financial audits across a range of agencies, looking at a range of processes. What is your experience on these sorts of things? It is going beyond a little bit what you are saying in terms of the financial audit. It is actually drawing out whether the financial or the physical management processes are sound. From year to year, maybe actually look at one sort of set, maybe procurement processes.

**Dr PFLUGRATH**—To me, it sounds like something akin to almost providing best practice guides or something for government departments and agencies to say, 'Well, we've done this range of financial statements, and there seem to be these particular issues.' If it were a means by which the Auditor-General then is able to assist agencies and departments in the conduct of their work by pointing out common areas of concern, I would think that was probably a good thing.

**Mr STRINGER**—Yes. I think some of the other auditors-general do that and perhaps they have done that for some time.

**Mr RICH-PHILLIPS**—These are not so much best practice guides as comparative analysis or ratio analysis across local government, for example—78 local governments in one report, comparing their debt-equity ratios and various other metrics. So it is not so much an assessment of emerging issues across the sector as a comparison of entities within the sector.

**Mr STRINGER**—I imagine the Auditor-General presumably—I am not sure what he would have been thinking—would consider that to have been a service to the legislature, for your benefit.

**The CHAIR**—One of the issues which the committee is looking at in this regard is: the reports are very interesting and they are valuable, but where does that then put the Auditor-General in that role compared to the role of, say, the State Services Authority which undertakes specific sector type inquiries, or the ombudsman or, indeed—probably most importantly—the central agencies, usually Treasury and Finance, which produce accounting guidelines and reporting guidelines, or the Department of Premier and Cabinet here in Victoria? Are you seeing duplication, crossover; cross-fertilisation?

**Dr PFLUGRATH**—I would have to say that I am not familiar enough to be able to comment on it. As I say, my first impression was that it was something which would assist agencies, but if it is not, then I am not sure about that.

**The CHAIR**—That is generally our principle. We prefer not to shoot the wounded; we prefer to try and patch them up so they can carry on even better.

**Mr RICH-PHILLIPS**—I would say that they assist the legislature, and the other agencies that you spoke about—SSA and DPC et cetera—might produce that comparative material for government, but it is only the Audit Office that produces it independently for the parliament. If there are comparative documents by SSA, they are not made available to parliament. So I think they are very valuable—the Audit Office.

**The CHAIR**—I am just trying to make sure that we do not have duplication. Any other questions? Gordon, have you got any more?

**Mr RICH-PHILLIPS**—The only other issue I wanted to touch on was—and this ties in with your other comments about the management letters and, if I can phrase it this way, the clients being those charged with governance—who does the audit profession see the client being for a financial audit opinion? Who is the client there in a typical private sector scenario?

**Mr STRINGER**—First and foremost, the board of the company, if it is a company, or the trustees in the event of a trust. They are the two most common.

**Mr RICH-PHILLIPS**—Not the shareholders or the beneficiaries?

**Mr STRINGER**—Yes, the shareholders in a company, through the board, and the trustees in the case of a trust, and any other unit holders in the trust.

**Mr RICH-PHILLIPS**—The reason I asked that question was to lead to the second part of the matter I wanted to raise, which was the independence. How do you guarantee the independence of an auditor from the entity they are auditing, particularly if it is a recurring contract? Obviously with the Auditor-General, it is a recurring arrangement. I know this was an issue in the States some years ago.

**Dr PFLUGRATH**—I will refer my comments, initially anyway, to the private sector space, particularly since the turn of the century there have been a number of legislative reforms, both in the US and in Australia, under the CLERP 9 reforms to address the issue of independence. The Corporations Act is quite detailed, quite specific, in relation to those areas where it is considered that independence would be impaired through conflicts of interest. The whole code of ethics for professional accountants is about 95 pages and I think about 70 of them are devoted to independence and how you go about determining that you are independent—I may be overstating it slightly. But there is quite detailed discussion about the different threats that can arise as a result of your involvement with either the processes in preparing and then auditing your own work or being familiar with the client through a long engagement—being engaged for a long period of time—and so on.

The professional accountant and the assurance practitioner need to determine whether those threats do impair independence and whether there are safeguards in place to reduce it to an acceptable level. One specific issue you talked about where an auditor is engaged for a long period of time: there are rotation requirements within both the code of ethics and in the Corporations Act in Australia. The international code requires that if you have been involved as the engagement partner or the review partner for a period of seven years, you need to rotate. We have a more strict requirement in Australia. Under the Corporations Act, it is five years.

**Mr STRINGER**—And the code of ethics as well.

**Dr PFLUGRATH**—Sorry, the Australian code of ethics is also five years. In fact, with the new code next year, they are intending to expand that number of people who are subject to that rotation requirement to any partner or senior member who has been involved in the audit. Would that be correct?

**Mr STRINGER**—Yes, and of a division et cetera. Could I just supplement that? I agree with everything that Gary has said; it is factually correct. To my knowledge, all the auditors-general address the familiarity threat—which is the one I guess you are alluding to—by rotating their signing officers and having fairly strict rotation requirements. While the

Auditor-General retains overall responsibility, there are always delegations and, within the office, the senior officer would be rotated in accordance with those guidelines, to my knowledge.

**Mr RICH-PHILLIPS**—With the private sector, the rotation requirement is only for the partners and senior managers rather than the firm?

**Mr STRINGER**—Yes, that is right. The requirement currently only applies to listed entities under the Corporations Act but, within the code of ethics, you need to look at the principles and apply those equally.

**The CHAIR**—How far down does that go?

**Mr STRINGER**—It is normally the partner and the review partner.

**The CHAIR**—Okay. I have seen some applications which talk about 'engagement partners'.

Is that someone who happens to be the partner who happens to be the CEO for a few years and then down below you have someone who is more actively doing the things?

**Mr STRINGER**—The engagement partner is normally considered to be the person who signs the accounts. So in the case of the Audit Office, the signing officer is considered to be partner equivalents.

**The CHAIR**—So it is equivalent to the engagement partner who has primary responsibility.

**Mr STRINGER**—For the big end of town, the listed entities, you have what is called an 'engagement quality control reviewer' required.

**The CHAIR**—Quality review partner, yes.

**Dr PFLUGRATH**—Yes.

**MR STRINGER**—That partner also has to rotate; it is the same five-year restriction.

**The CHAIR**—Then the next level down are the people who are doing the extensive jobs, who are probably doing all the work.

**Mr STRINGER**—There are no specific requirements.

**Dr PFLUGRATH**—There are no specific requirements, but you could not imagine those people being there for a very long period of time, because they would typically be promoted or move on anyway.

**The CHAIR**—Yes. They would not be doing something for 20 years.

**Mr STRINGER**—No, highly unlikely.

**Ms HUPPERT**—Once it is a professional purposes firm anyway.

**Dr PFLUGRATH**—The other point we should mention is the cooling-off period now as well, which requires that, if you were the engagement partner or the review partner, there is a period of two years before you can then go and join that client as a member of the client's team.

**Mr STRINGER**—Or you rotate off for two years before going—

**Dr PFLUGRATH**—Until you return, yes.

**Mr STRINGER**—The committee might be interested in some recent developments in the United Kingdom, whereby the five-year rotation rule there has recently been eased a little bit to a maximum of seven years for audit partner rotation, but the additional two years—taking it from five to seven years—would be only with the express consent of the audit committee in that case. That came in last year in the UK. What we are hearing from federal Treasury here is that there is no appetite for change in Australia, but if there were to be a change, instead of that two-year time-out you would expect the time-out to go to five years, if there were to be any movement in that. But I suspect nothing in the immediate future.

**Mr RICH-PHILLIPS**—Thank you.

**Ms HUPPERT**—I would like to go to 5.2.8 of the discussion paper, 'Annual audits of performance indicators'. This is another issue where there has been some discussion about whether the role of the Auditor-General in their annual report should be expanded. This is also, I suppose, related to the government's reporting changes towards outcome rather than output reporting; therefore, whether there should be an additional power for the Auditor-General to report on performance controls and KPIs. I know you refer to some of the changes brought under the Sarbanes-Oxley Act, which I understand has been modified somewhat recently. But in terms of requirements here, could you expand your views a little bit on that suggestion.

**Dr PFLUGRATH**—Yes. We did confine our response to the internal controls, rather than looking at the performance indicators. But we have subsequently discussed that issue and our view is that there should be no reason why you should not be looking for assurance around key performance indicators, as long as those key performance indicators are capable of being objectively analysed.

**The CHAIR**—They are robust enough.

**Dr PFLUGRATH**—You have the concept in all of this that you have to have appropriate subject matter and suitable criteria.

**The CHAIR**—We spend a lot of time on that, don't we?

**Dr PFLUGRATH**—We do.

**Ms HUPPERT**—Yes. I guess the issue we have here is how you determine what the KPI should be.

**Dr PFLUGRATH**—If you go back to the private sector, the determination of those indicators would be up to the client, if the client is compliant with legislation. Greenhouse gas emissions is probably a good example. If the Department of Climate Change specifies the sorts of indicators they want reported on and they are quite clear that there is a framework, there are suitable criteria against which an auditor or an assurance practitioner can make that assessment, then there is no reason why they cannot. But it is not up to the assurance practitioner to determine that framework or to determine those indicators, because they have to come along independently and assess against them. That is what we mean by being able to be subject to objective analysis.

**Mr STRINGER**—Appropriate subject matter.

**Dr PFLUGRATH**—Being auditable, yes.

**Mr STRINGER**—You would imagine that the legislature somewhere along the line could and would determine what the KPIs are.

**The CHAIR**—We do ask that.

**Mr STRINGER**—They have to be objective and capable of being audited. I suppose that is the baseline.

**Dr PFLUGRATH**—In some ways, if you look at what is happening in, say, the sustainability area already, a lot of the reports that are being issued on sustainability reporting by companies are nothing more than KPIs, aren't they? There are certain indicators: they are complying with, say, the Global Reporting Initiative framework and that then allows an assurance practitioner to come in and make an assessment against the framework. I think there are precedents in that area.

**The CHAIR**—Gordon, anything else?

**Mr RICH-PHILLIPS**—No, thanks, Bob.

**The CHAIR**—I think we have pretty much gone through this. I am not sure that the smaller entities are—it is interesting what you have said there regarding the limited by guarantee arrangement. Of course, we do have an act before the parliament at the moment—I think we can comment on that, can't we, Gordon?—in terms of financial management, where there is a suggestion that authorities be defined in three different ways.

**Mr RICH-PHILLIPS**—Three tiers by criteria, yes.

**The CHAIR**—Which is something similar. But it is an attempt to put some order into quite a lot of authorities. We do get some 600-odd annual reports, which I think are far too many, particularly if they all arrive at the same time. That is very helpful. Is there anything else you might want to raise that we might have missed out, do you think?

**Dr PFLUGRATH**—I do not think so. I think that covered the key areas we were—

**Mr STRINGER**—Yes, I think so.

**The CHAIR**—Thank you very much. That concludes consideration of evidence provided by CPA Australia, the Institute of Chartered Accountants and the National Institute of Accountants. I thank Dr Pflugrath and Mr Stringer for their attendance today. It has been a useful session. I do not think there were any questions on notice, from memory. We would have followed those up at a later date. We will send you a copy of the transcript for verification in due course.

**Witnesses withdrew.**

**Hearing suspended.**