New South Wales Auditor-General's Report
Financial Audit

Volume One 2016
Areas of focus from 2015

audit
office
OF NEW SOUTH WALES

The role of the Auditor-General

The roles and responsibilities of the Auditor-General, and hence the Audit Office, are set out in the *Public Finance and Audit Act 1983*.

Our major responsibility is to conduct financial or 'attest' audits of State public sector agencies' financial statements. We also audit the Total State Sector Accounts, a consolidation of all agencies' accounts.

Financial audits are designed to add credibility to financial statements, enhancing their value to end-users. Also, the existence of such audits provides a constant stimulus to agencies to ensure sound financial management.

Following a financial audit the Audit Office issues a variety of reports to agencies and reports periodically to parliament. In combination these reports give opinions on the truth and fairness of financial statements, and comment on agency compliance with certain laws, regulations and government directives. They may comment on financial prudence, probity and waste, and recommend operational improvements.

We also conduct performance audits. These examine whether an agency is carrying out its activities effectively and doing so economically and efficiently and in compliance with relevant laws. Audits may cover all or parts of an agency's operations, or consider particular issues across a number of agencies.

Performance audits are reported separately, with all other audits included in one of the regular volumes of the Auditor-General's Reports to Parliament – Financial Audits.

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Pursuant to the *Public Finance and Audit Act 1983*, I present Volume One of my 2016 report.

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Acting Auditor-General
25 February 2016

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This report focuses on key observations from financial and performance audits in 2015. The findings have been broadly classified into four themes, which has informed the focus of financial and performance audits for 2016.

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Only two qualified audit opinions were issued on 2014-15 financial statements, and reported misstatements continued to fall. Early close procedures allow issues to be resolved and financial reporting risks to be addressed early.

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Some agencies did not complete asset revaluations and quality reviews of the results before the early close deadline.

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Many agencies had large variances between actual results and original budgets.

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Some service level agreements with shared service providers were not finalised on a timely basis.

Financial performance and reporting

The quality of financial reporting continues to improve

Unqualified audit opinions were issued for NSW public sector agencies except for TAFE NSW and the Office of the NSW State Emergency Service.

Since Treasury introduced its 'early close procedures' initiative in 2011-12, the number of reported misstatements and significant matters have fallen significantly across the NSW public sector, reflecting the improved quality of financial reporting.

Early close procedures, particularly asset revaluations, can be improved further

Similar to last year, opportunities to improve early close procedures exist in some agencies, including:

- compiling quality work papers for revaluations of property, plant and equipment which supports management's proposed accounting treatments, judgements and assumptions
- resolving all significant accounting issues during the early close process, or documenting a clear path towards timely resolution.

Budgeting processes require further improvement

Many agencies' actual results varied significantly from the original budgets highlighting the need for improved budgeting processes.

Financial controls

High risk financial control deficiencies continued to decrease

The 2014-15 audits identified fewer high risk financial control weaknesses than in previous years. However, areas were identified where internal controls can be improved.

The number of repeat financial control issues remains high

Over 200 repeat financial control issues were reported across the NSW public sector. Internal control weaknesses increase the risk of fraud and error and need to be addressed in a timely manner.

Agencies continue to face significant challenges in managing information security

Eighty five per cent of all reported Information Technology issues related to user administration, privileged access and password parameters. This was primarily due to implementing new systems and agency restructures. Such periods of change often result in information security being overlooked when it is most critical.

Annual leave balances continue to exceed whole-of-government targets

At 30 June 2015, most NSW public sector agencies had staff with annual leave balances exceeding the whole-of-government target of 30 days.

The Transport, Education and Health clusters have significant maintenance backlogs

Roads and Maritime Services (RMS), the Department of Education and NSW Health had estimated maintenance backlogs of $5.3 billion, $732 million, and $323 million respectively at 30 June 2015.

Governance

Governance arrangements at the cluster level are not clear

The NSW Public Sector Governance Framework does not clearly articulate the role of the cluster Secretary and Chief Financial Officer and does not clarify governance arrangements at the cluster level.

Treasury's Financial Management Transformation program aims to improve financial governance, budgeting and reporting, as well as administrative and accountability arrangements to enhance cluster operations.

Numerous governance issues were identified across the NSW public sector in 2014-15

Agencies, particularly the principal departments, should benchmark their governance arrangements against relevant better practice guides such as the Audit Office's Governance Lighthouse Checklist and address identified gaps promptly.

Numerous governance issues were identified across the NSW public sector in 2014-15. The Audit Office published its updated 'Best Practice Guide Governance Lighthouse – Strategic Early Warning System' in 2013-14 and some agencies have started using the principles in the guide to identify areas requiring attention.

Some agencies have not implemented the Government's decisions, policies and procedures

Assurance provided to the NSW Government and sponsor agencies on the viability of large projects was often inadequate. Government policy was not always followed or properly communicated to those responsible for implementing it.

Incidents of alleged fraud and corruption have occurred in numerous agencies

In 2014-15, numerous agencies referred fraud and corruption matters to the NSW Independent Commission Against Corruption and the Police Integrity Commission.

To reduce the risk of fraud, agencies need to reassess their fraud controls against the revised Audit Office's Fraud Control Improvement Kit.

It is not clear where responsibility lies for Enterprise Risk Management at a whole-of-government level

Risk management is currently managed at an individual agency level. Although Treasury has issued TPP 12-03: Risk Management Toolkit for the NSW Public Sector and TPP 15-03: Internal Audit and Risk Management Policy for the NSW Public Sector, it is not clear where responsibility lies for various aspects of enterprise risk management at a whole-of-government level.

Service delivery

Some agencies need to improve contract management processes

Some agencies self-assessed their contract management processes against the Audit Office's Better Practice Contract Management Framework and identified gaps in their current practices.

Agreements with shared service providers were not always finalised in a timely manner

Some agencies have not finalised service level agreements with shared service providers in a timely manner. Service level agreements clarify service levels and expectations, cost allocations and key performance indicators.

Looking forward

In 2016, the Audit Office will build on its work of 2015 and continue to report financial audit findings across four themes - financial performance and reporting, financial controls, governance and service delivery.

Financial Audit

In 2015, financial audit placed greater emphasis on governance by commenting on:

• risk management maturity in some key agencies
• governance arrangements for the ten clusters that make up the NSW public sector
• fraud controls
• compliance management.

This will continue in 2016. More work will be done on risk management in some key government agencies and the Office will review whether government agencies are meeting their public access obligations under the *Government Information (Public Access) Act 2009* for contracts they have with the private sector.

Performance Audit

In 2015, performance audits focused on areas of public sector reform by examining:

• productivity in the NSW public sector
• data quality in the health sector
• commissioning of government services in transport, education, and human services
• governance over major capital projects, including reasons for deviations from budget and scope, and how well project assurance is operating.

In 2016, performance audits will build on topics that target areas of government reform and examine progress against the Government's 30 'State Priorities' including 12 'Premier Priorities'.

Follow the money powers

Many parliaments now have legislation that enables Auditors-General to 'go beyond' the boundaries of the agencies commissioning a service to examine the processes within the organisation providing the service ('follow the money' powers).This is not the case in New South Wales.

In its September 2013 report to Parliament on the Efficiency and Effectiveness of the Audit Office of New South Wales, the Public Accounts Committee recommended the *Public Finance and Audit Act 1983* be amended to enable the Auditor-General to 'follow the dollar' by auditing functions performed by private contractors and other non-government organisations on behalf of the State in the delivery of government programs.

A broader and more robust audit mandate should be considered for the Auditor-General to effectively report on government service delivery.

Financial Performance and Reporting

Financial performance and reporting are important elements of good governance. Confidence in public sector decision making and transparency is enhanced when financial reporting is accurate and timely. Effective financial management and reporting by agencies helps key stakeholders, such as the NSW Government, make effective decisions and achieve desired outcomes efficiently.

This chapter outlines our audit observations and conclusions relating to the financial performance and reporting of NSW public sector agencies for 2014-15.

Financial reporting	
Observation	**Conclusion**
Only two qualified audit opinions were issued on 2014-15 financial statements, and reported misstatements continued to fall. Early close procedures allow issues to be resolved and financial reporting risks to be addressed early in the audit process.	Further improvements to early close procedures and more frequent preparation of financial reports will help reduce reporting timeframes, improve financial statement quality and increase audit efficiency.
Some agencies did not complete asset revaluations and quality reviews of the results before the early close deadline.	To realise the benefits of early close procedures, asset revaluations should be completed and quality reviewed before the early close deadline.

Financial performance	
Observation	**Conclusion**
Many agencies had large variances between actual results and original budgets.	To improve financial performance and decision making, agencies' budgeting processes should be robust and use consistent approaches to improve accuracy.

Quality of Financial Reporting

Only two qualified audit opinions were issued on 2014-15 financial statements

Unqualified audit opinions were issued on the 2014-15 financial statements of NSW public sector agencies except for the Technical and Further Education Commission (TAFE NSW) and the Office of the NSW State Emergency Service.

Serious system limitations prevented TAFE NSW from providing sufficient and appropriate evidence to support recorded student revenue and related transactions.

The Department of Education (the department) commenced the Learning Management and Business Reform (LMBR) program in 2006. An element of the LMBR program was the replacement of various legacy systems with an integrated system to manage student administration across all ten TAFE NSW Institutes. In October 2014, the department delivered the Student Administration and Learning Management (SALM) solution to TAFE NSW with the implementation of the Educational Business Software (EBS) system.

Significant system implementation issues resulted in:

- institutes experiencing delays in enrolling students
- large volumes of manual processing required by TAFE NSW staff
- inability to fully reconcile cash balances
- difficulties in reconciling student enrolments with revenues recorded in the financial statements.

There were also significant issues with the design of user access and security controls.

The Office of the NSW State Emergency Service did not implement effective controls over donation and fundraising activities to ensure the completeness of recorded revenues.

The quality of financial reporting continues to improve

Since Treasury introduced its 'early close procedures' initiative in 2011-12, the number of reported misstatements and significant matters have fallen significantly across the NSW public sector. This is largely attributed to the early resolution of accounting issues as a part of the early close procedures, which helps agencies meet earlier reporting deadlines and improve the quality and accuracy of financial reporting.

Significant matters identified by the 2014-15 audits and reported to the portfolio Minister, Treasurer and agency head in a Statutory Audit Report related to:

- going concern issues
- significant control deficiencies and system limitations
- non-compliance with legislation
- poor quality of financial reporting and delays in submitting financial statements
- completeness of recording donation revenues
- asset revaluations
- significant debt write-offs.

Timeliness of Financial Reporting

Audit opinions issued within three months of year end continue to increase

Most agencies submitted their financial statements on time and most audits were completed before or by the statutory deadlines.

Since the introduction of mandatory early close procedures in 2011-12, the Audit Office has issued significantly more audit opinions within a shorter period of time. In 2014-15, 229 audit opinions were issued within three months of the year end, compared to only 67 in 2010-11.

Early close procedures improved the timeliness of financial reporting

While agencies were broadly successful in performing 2015 early close procedures for year-end reporting purposes in 2014-15, more frequent preparation of financial reports will help improve the quality and timeliness of year-end financial reporting. It will also improve the financial management of the sector, particularly if adequate rigour is applied to the process.

Agencies were given less time to complete early close procedures and proforma financial statements. The deadline for audit teams to report audit findings was also reduced. Bringing the deadlines forward generally helped ensure a smoother year-end process as it allowed more time to resolve issues.

The table below shows the reduced deadlines for early close procedures over the past three years.

Key dates			
	2015	**2014**	**2013**
Agencies provided results of early close procedures to the Audit Office by	27 April	27 May	28 May
Audit Office provided feedback on early close procedures by	29 May	30 June	As agreed with agencies

Early close procedures are designed to bring forward traditional year-end activities, such as valuations of assets and resolution of financial reporting issues, and to reduce reporting timeframes and improve quality.

Agencies will not always be able to fully resolve significant and complex accounting issues during the early close process. If this is the case, it is important for agencies to document a clear path towards timely resolution and ensure appropriate stakeholders, including Treasury, are kept informed. The documentation should set out the issue, current status, key aspects needing resolution, and who is responsible for the expected deliverables.

Most agencies reconciled key account balances, performed monthly accruals and prepared pro-forma financial statements. Most performed management reviews of monthly reconciliations and reports, and included meaningful variance analyses and explanations in monthly reports.

Opportunities to improve early close procedures exist in some agencies, including:

• compiling quality work papers for revaluations of property, plant and equipment which supports management's proposed accounting treatments, judgements and assumptions
• resolving all significant accounting issues during the early close process, or documenting a clear path towards timely resolution.

Treasury is conducting a 'hard close pilot' with nine agencies in 2015-16. The pilot will help determine if hard close procedures should be adopted on a wider basis. Expected benefits include:

• earlier identification of problems and issues
• ability to spread workloads and manage resources during peak periods
• earlier tabling of annual reports.

Asset revaluation processes can improve

Although most agencies complied with Treasury's early close procedure requirements, there are opportunities for further improvement, particularly asset revaluations.

Numerous agencies did not complete asset revaluations by the early close deadline. In some cases, the revaluation results were not subject to a robust quality review before being included in the financial statements and early close supporting work papers.

Performance against Budget

Budgeting processes require improvement

Many agencies' actual results varied significantly from the original budgets. For instance, the local health districts/specialty networks' original budgets excluded $860 million of capital funding. This highlights the need for agencies to adopt more robust and consistent approaches to improve budgeting processes.

The Treasurer has continued to communicate with agency chief financial officers the importance of accurate financial information at various forums. The Treasurer's request for the Auditor-General to review the estimates and forecasts in the 2014-15 'Half Yearly Budget Review' and 2015-16 'Budget Papers' was also aimed at improving the overall quality of budgets and projections.

Financial Controls

Appropriate financial controls help ensure the efficient and effective use of resources and the implementation and administration of agency policies. They are essential for quality and timely decision making to achieve desired outcomes.

This chapter outlines audit findings on the financial controls of NSW public sector agencies for 2014-15.

Financial controls	
Observation	**Conclusion**
High risk financial control deficiencies identified by audit continued to decrease.	Most agencies' key financial controls were designed appropriately and operated effectively.
Over 200 repeat financial control issues were reported across the NSW public sector.	The number of repeat financial control issues remains high. These issues need to be addressed in a timely manner.
Eighty five per cent of all reported Information Technology issues were related to information security.	Agencies continue to face significant challenges in managing information security.
Most NSW public sector agencies had staff with annual leave balances exceeding the whole-of-government target of 30 days.	Most agencies are finding it difficult to reduce employee annual leave balances to the Government's target of 30 days.
RMS, the Department of Education and NSW Health had estimated maintenance backlogs of $5.3 billion, $732 million and $323 million respectively at 30 June 2015.	RMS advised this level of backlog maintenance does not impact its service delivery.
	The Department of Education's maintenance funding cannot keep pace with the growth in school maintenance needs. The Department has developed some strategies to address this issue.
	Local health districts/specialty networks advised they are now able to ensure maintenance works are targeted to meet future service needs.

Internal Controls

High risk financial control deficiencies continued to decrease

The 2014-15 audits identified fewer high risk financial control weaknesses than in previous years. However, areas were identified where internal controls can be improved. These were reported to agencies' management with recommendations to address the weaknesses. Generally, however, agencies' internal controls were appropriately designed and operated effectively to produce reliable and timely financial reports.

Breakdowns and weaknesses in internal controls increase the risk of fraud and error and need to be addressed in a timely manner.

The number of repeat financial control issues remains high

Over 200 repeat financial control issues were reported across the NSW public sector. Most were identified in the health, trade and investment, planning and environment and transport cluster agencies. Some issues can take longer to address due to resource constraints and/or the complexity of the issue. Audit and Risk Committees continue to monitor and advise agency heads on the implementation of audit recommendations.

Common control weaknesses identified during the 2014-15 audits include:

•   inadequate policies and procedures
•   non-compliance with processes and regulations
•   no centralised contract registers
•   lack of segregation of duties
•   inadequate review of reconciliations and reports
•   weaknesses in information technology controls (see further details below)
•   service level agreements with service providers not finalised in a timely manner
•   annual impairment assessment of property, plant and equipment not performed and/or reviewed
•   management of excess annual leave balances
•   timesheets not approved.

Information Technology

Agencies continue to face significant challenges in managing information security

Most of the issues identified and reported over the last three years have been in information security. Key control weaknesses relate to user administration, privileged access and password parameters. These account for 79 per cent of all reported Information Technology (IT) issues and primarily occur when agencies implementing new systems and restructure their operations. Such periods of change often result in information security being overlooked when it is most critical.

Twenty-two per cent of the issues reported in 2014 were repeated in 2015. While the percentage of repeat issues has fallen from 30 per cent in 2014 and 36 per cent in 2013, they still account for a high number of issues. IT solutions are often costly and take a long time to fully implement. Agencies need to manage IT risks effectively, especially during times of transition.

A well-managed and effective IT control environment:

•   has a robust information security management framework
•   focuses on managing IT security risks during times of change
•   ensures financial systems are capable of supporting critical business processes in the event of a disaster
•   regularly reviews system controls and associated business processes, especially in a changing environment
•   defines and monitors the accountabilities and responsibilities in shared service relationships.

The information systems of 73 agencies were audited in 2015. The audits focused on the IT processes and controls supporting the integrity, availability and security of financial data used to prepare the financial statements.

The number of audits performed and findings reported to those charged with governance over the last three years is as follows:

• 2015: 73 audits performed and 169 issues reported.
• 2014: 77 audits performed and 198 issues reported.
• 2013: 80 audits performed and 222 issues reported.

The audits identified opportunities to improve IT control environments in the following areas:

Audit area	Description	Distribution of issues identified		
		2015 %	2014 %	2013 %
Information security	Controls that prevent or detect unauthorised use of and changes to financial systems and data	85	80	73
System change control	Change controls over financial systems and supporting infrastructure are effectively developed, tested, implemented and maintained	12	16	17
Data centre and network operations	Controls that ensure the integrity of information as it is processed, stored or communicated	3	4	10

Some agencies are not complying with Government IT Policy

The information security weaknesses reported indicate some agencies are not fully complying with the NSW Government Digital Information Security Policy (DISP), which was updated in 2015. It has the following core requirements for agencies and shared service providers:

• they must have an Information Security Management System (ISMS) based on a comprehensive assessment of the risk to digital information and digital information systems
• the ISMS must, as a minimum, contain measures that address the risks associated with the security categories specified in the policy, taking into account the controls identified in the Treasury Policy and Guideline Paper TPP09-05 'Internal Audit and Risk Management Policy for the NSW Public Sector', ISO 31000 'Risk management - Principles and guidelines', ISO 27002 'Information technology - Security techniques - Code of practice for information security controls' and related standards, and agency business continuity and disaster recovery management
• they must maintain compliance with ISO 27001 'Information technology - Security techniques - Information security management systems – Requirements'
• they must disseminate digital information security events, incidents and near misses that pose a threat across the public sector through the Digital Information Security Community of Practice in a time and manner appropriate to the nature and magnitude of the threat
• they must attest annually to the adequacy of their digital information and information systems security.

All agencies should consider the recommendations in the 2015 performance audit 'Security of critical IT infrastructure' as many are equally relevant to security of key financial systems. These were to:

• develop a comprehensive security plan
• identify, assess and report security risks
• improve monitoring and logging of security incidents
• determine appropriate controls to limit unauthorised access.

Disaster Recovery Planning

Some agencies do not have disaster recovery plans

Since 2012, Volume One of the Auditor-General's Report to Parliament has reported on disaster recovery planning for large agencies. In 2015, the Audit Office reviewed 30 agencies to determine whether they had a disaster recovery plan (DRP) for the financial systems most relevant to producing the financial information they use to manage their businesses and produce financial reports, and whether they regularly tested it. The review found:

• four agencies did not have a DRP

• three agencies' DRPs were not tested in accordance with the plan

• one agency had no DRP for one of its four significant financial systems.

Volume Four of the 2015 Auditor-General's Report to Parliament detailed the findings from the review.

The two most essential elements of disaster recovery planning are having an effective DRP and testing it regularly. Without a DRP, unforeseen events increase the risk of high financial costs, reputational loss and negative impacts on key stakeholders.

Human Resources

Annual leave balances continue to exceed whole-of-government targets

NSW public sector agencies are finding it difficult to reduce annual leave balances to meet whole-of-government objectives. At 30 June 2015, most agencies had staff with annual leave balances exceeding the target of 30 days.

Implications of excessive leave balances include:

• possible work health and safety implications

• disruptions to service delivery if key employees are absent for lengthy periods to reduce leave balances

• employee fraud may remain undetected

• the associated financial liability generally increases over time as salaries increase.

Treasury Circular TC14/11 'Reduction of Accrued Recreation Leave Balances' requires agencies to make all reasonable attempts to reduce accrued employee recreation leave balances to a maximum of 30 days or less by 30 June 2015, within the constraints of relevant industrial instruments and legislation.

Asset Management

The Transport, Education and Health clusters have significant maintenance backlogs

RMS reported a maintenance backlog of $5.3 billion at 30 June 2015, but overall ride quality has improved. RMS spent $612 million on asset maintenance in 2014-15, $82.0 million more than planned. Sydney Trains advised its maintenance backlog of $250 million has no impact on safety or service levels.

The Department of Education estimated maintenance backlog of $732 million at 30 June 2015, an increase of $195 million from 2013-14. This is due to maintenance funding not keeping pace with the growth in school maintenance needs. Total school maintenance funding increased from $321 million in 2013-14 to $347 million in 2014-15. However, less than half the school maintenance budget was used to address backlog maintenance.

The Department of Education has the following strategies to respond to the increasing backlog maintenance:

- The annual Total Asset Management (TAM) submission to Treasury highlights the increasing funding gap associated with maintenance.
- The Secondary Schools Renewal Program, which is a capital funded program targeted at high schools, is designed to ensure the current maintenance backlog is a key indicator in determining those schools that will receive funding.
- The revenue generated from the Department's asset disposal program is allocated to schools with the highest maintenance liability.

NSW Health quantified its total backlog maintenance for the first time in 2014-15. Total estimated backlog maintenance was $323 million at 30 June 2015. Backlog maintenance estimates for individual health entities ranged between $2.4 million and $83.9 million at 30 June 2015.

The 2014 Auditor-General's Report to Parliament recommended the Ministry of Health develop asset maintenance plans, and identify and measure their maintenance backlog.

The Ministry of Health advises:

- a high-level project plan with deliverable dates for key maintenance activities has been developed, and the milestones achieved against the plan were monitored and reported
- health entities have identified and measured maintenance backlogs in 2015 Asset Strategic Plans
- those health entities required to prepare Asset Strategic Plans have also prepared asset maintenance plans.

Governance

Governance refers to the high-level frameworks, processes and behaviours established to ensure an entity meets its intended purpose, conforms with legislative and other requirements, and meets the expectations of probity, accountability and transparency.

Governance	
Observation	**Conclusion**
Governance arrangements at the cluster level are not clear.	Treasury's Financial Management Transformation program aims to improve administrative and accountability arrangements to enhance cluster operations.
Some audits identified issues with the agencies' compliance and fraud frameworks.	Agencies can benchmark their governance against the principles from the Audit Office's Best Practice Guide 'Governance Lighthouse – Strategic Early Warning System' to assess and improve governance practices, where necessary.
Some agencies have not implemented the government's decisions, policies and procedures.	Agencies' strategic plans and activities should be consistent with Expenditure Review Committee and whole-of-government decisions, policies and procedures.
Incidents of alleged fraud and corruption have occurred in numerous agencies.	To reduce the risk of fraud, agencies need to reassess their fraud controls against the revised Audit Office's Fraud Control Improvement Kit.
It is not clear where responsibility lies for Enterprise Risk Management at a whole-of-government level.	The government should determine and establish responsibility and accountability for Enterprise Risk Management at the whole-of-government level.
Some agencies did not maintain a centralised conflicts of interest register and/or a gifts and benefits register.	Agencies need to develop and maintain centralised conflicts of interest and gifts and benefits registers.

Governance Framework

Governance arrangements at the cluster level are not clear

The NSW Public Sector Governance Framework does not clearly articulate the role of the cluster Secretary and Chief Financial Officer (CFO) and does not clarify governance arrangements at the cluster level.

The Framework, released by the Department of Premier and Cabinet in February 2013, provides guidance for determining the appropriate governance arrangements and the level of government control required for those functions the NSW Government is accountable for.

It was designed as a tool to help with establishing new entities and when reviewing existing entities in the executive branch of government. While it guides and articulates the expected relationships between Coordinating and Portfolio Ministers, and Secretaries, Chief Executives and agency Boards, the authority, autonomy and accountability of the Secretary and CFO should be clear if cluster governance is to be effective and meet NSW State Priorities.

The Financial Management Transformation program is revising governance arrangements

Treasury's Financial Management Transformation (FMT) program aims to improve financial governance, and the budgeting and reporting arrangements of the NSW public sector as well as administrative and accountability arrangements to enhance cluster operations.

Governance Issues

Numerous governance issues were identified across the NSW public sector in 2014-15

In 2014-15, some agencies self-assessed their governance arrangements against the Governance Lighthouse checklist, which is a strategic early warning system designed to help agencies identify areas which need attention. The self-assessments indicate some agencies have developed and implemented strategic and business plans with clear accountabilities and delegations, and regularly report against those plans.

However, governance can be improved by:

• requiring all staff to sign the code of conduct annually

• making the code of conduct publicly available

• making internal audit plans publicly available

• revising the continuous disclosure policy to provide for regular disclosure of performance information on key metrics, inputs, outputs, processes and outcomes, in addition to the annual report

• promoting disclosure of positive and negative information

• publishing the continuous disclosure policy on the agency's website

• building a strong risk management culture, which annually reviews the risk management framework, links to corporate planning and has a shared understanding of management's risk appetite

• implementing a statement of business ethics which guides private sector partners and suppliers on expected behaviours in business dealings

• implementing a fraud and corruption policy

• implementing a compliance framework.

Good governance promotes public confidence in government and its agencies, and should improve service delivery and result in more efficient use of resources.

The Audit Office published an updated Best Practice Guide 'Governance Lighthouse - Strategic Early Warning System' in 'Volume One 2015 Areas of focus from 2014'. The lighthouse was broadened to align the values supporting eight governance principles with the Public Service Commission's 2014 Ethical Framework for the NSW Government sector that supports good governance.

Government Decisions

Some agencies have not implemented the government's decisions, policies and procedures

Independent assurance provided to the NSW Government and sponsor agencies on the viability of large projects was often inadequate. Government policy was not followed or properly communicated to those responsible for implementation.

For example:

- Neither Destination NSW nor the Sydney Opera House complied with all government advertising requirements.
- The Department of Premier and Cabinet does not have a monitoring program to systematically follow-up agencies which do not comply with the government's advertising requirements.
- Transport for NSW and RMS could not provide compelling economic evidence or financial argument to support the construction of the Tibby Cotter Walkway and the tight construction deadline.

Agencies' strategic plans and activities should be consistent with Expenditure Review Committee and whole-of-government decisions, policies and procedures.

Fraud and Corruption

**Incidents of alleged fraud and corruption occurred in numerous agencies**

In 2014-15, numerous agencies referred fraud and corruption matters to the NSW Independent Commission Against Corruption and the Police Integrity Commission.

Agencies should refer to the 2015 Audit Office Fraud Control Improvement Kit (released in February 2015), which consolidates previously issued Audit Office resources into one document and places additional focus on the cultural elements that need to be present in an effective fraud control framework.

Risk Management

Enterprise Risk Management

The increasing complexity of government businesses, including public, private partnership projects, expansion of outsourcing initiatives, the sale and recycling of government assets and digital revolution (specifically cyber risk) reinforces the need for a whole-of-government risk management approach to deal with inter-related and inter-dependent risks. An integrated and effectively implemented risk management framework can improve the quality of service delivery outcomes while creating value and achieving cost savings.
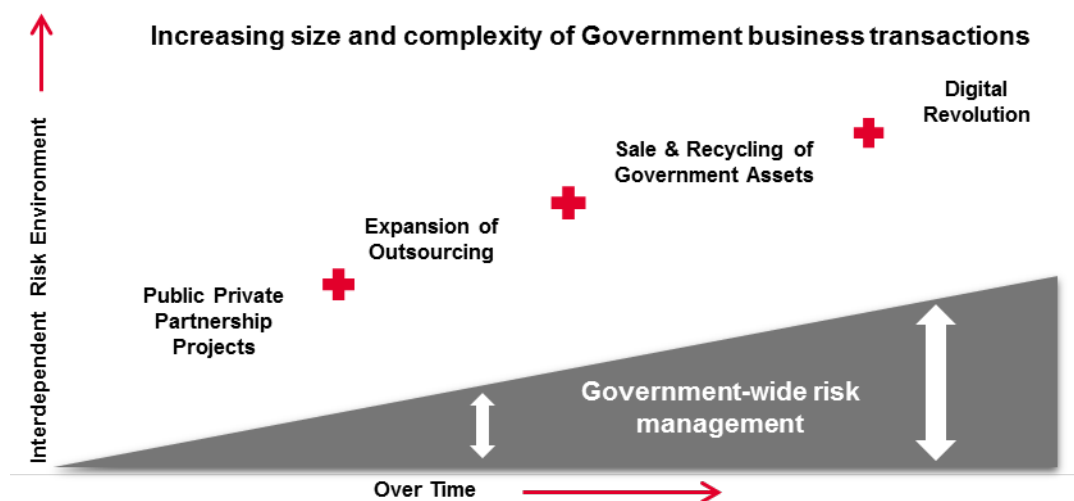
It is not clear where responsibility lies for Enterprise Risk Management at a whole-of-government level

Risk management is currently managed at individual agency level. Although Treasury has issued TPP 12-03: Risk Management Toolkit for the NSW Public Sector and TPP 15-03: Internal Audit and Risk Management Policy for the NSW Public Sector, it is not clear where the oversight responsibility lies for various aspects of enterprise risk management (ERM) at a whole-of-government level.

TPP 15-03, issued in July 2015, is principle based guidance, which clearly articulates core requirements for agencies to demonstrate they are effectively managing risks. It acknowledges agency diversity and allows them flexibility in managing their affairs. The risk framework in each agency should be fit-for-purpose to ensure the design and application of qualitative and quantitative risk management approaches, tools and techniques is appropriate. Some agencies may need more sophisticated risk management processes than others to suit the size and complexity of their activities.

In June 2015, the Audit Office asked key staff in 77 agencies to self-assess their risk management processes and risk management maturity.

On average the risk maturity of State Corporations was slightly better than Departments. Generally, the self-assessments showed respondents believe their agencies have enterprise risk management frameworks covering all major risk types. However, most respondents indicated their agency had not implemented standardised risk management processes consistently across the organisation.

The self-assessments followed the Audit Office's Risk Management Maturity Toolkit, which is based on the principles and guidelines of International Standards on Risk Management AS/NZS ISO 31000: 2009 Risk Management and Treasury Policy Guidelines TPP 12-03 and TPP 15-03. The toolkit is published on the Audit Office website.

Only 15 percent of surveyed agencies fully implemented their risk management framework

The self-assessments indicated only 15 percent of agencies surveyed had a fully implemented and consistently applied risk management framework and related processes.

	Maturity	Agencies
Optimised	Risk management is embedded into day to day decision making Sophisticated and advanced risk management processes are used Key Risk Indicators linked to performance measures and incentives	0%
Consistent-implemented	Risk management processes are measured and evaluated for continuous improvement ERM is fully implemented and consistently applied Key Risk indicators are collected and monitored consistently	15%
Consistent-designed	Communication and accountability exists throughout the business but not all processes have been fully implemented Policies and risk assessment criteria are designed and documented ERM framework designed and covers all risks	47%
Inconsistent	Risk management activities are conducted inconsistently Limited alignment of risk to corporate strategies There are some formal processes in place for a few risks	37%
Initial	Minimal awareness of the importance of risk management Ad hoc and mostly reactive – left to the individual not entity-wide Processes undefined and undocumented	1%

Better Practices in Risk Management

Some of the better practices employed in the NSW public sector identified through the self-assessment responses are detailed below.

Strong leadership and commitment is required for effective governance

Practices employed by agencies assessed to have consistently implemented risk management in the areas of Governance, Monitoring and Review are shown below.

Governance, monitoring and review	
Better practice	**Example**
Robust and meaningful oversight of risk by senior management that is appropriate for the size and nature of the organisation and the environment it operates in	Some agencies have a separate committee to monitor key and emerging risks facing the business. They employ appropriate mechanisms to oversight control activities and ensure recommendations from Audit and Risk Committees (ARC) are actioned effectively and on a timely basis
Roles and responsibilities for risk management compliance and assurance are clearly articulated and designed to meet the "three lines of defence" principles	As a first line of defence, operational staff are aware of their responsibilities as risk owners and for ensuring they have appropriate mitigating controls in their business units. As a second line of defence, the risk manager ensures risk management principles are applied consistently across the business, co-ordinates risk management activities and ensures continuous improvement in risk management capabilities. The third line of defence is an internal audit function that independently reviews the design and operating effectiveness of controls, evaluates the effectiveness of risk management processes and uses risk assessments to guide the focus of internal audit programs
The agency head, Board or equivalent conducts strategic risk management workshops to identify key enterprise risks	The agency heads ensure identified risks align to corporate strategy objectives and have risk owners. The ARC and risk owners monitor the key risks through dash board reports, which track changes in risk profiles and identify vulnerabilities and gaps in business processes
The level of risk the agency is prepared to accept or tolerate is communicated throughout the organisation	The tolerance level for the agency is articulated through a risk appetite statement

Systems need to be tailored to the entity's business processes

Practices employed by agencies assessed to have consistently implemented risk management in the area of Systems and Processes are shown below.

Systems and processes	
Better practice	**Example**
A holistic view is taken of risks across the agency, rather than on a 'silo' basis	A centralised risk management team co-ordinates the measurement and monitoring of interdependent risk management activities and links assessments to Government policies and cluster procedures
Standardised processes are applied at all levels using common risk terminology	Risk mitigation plans using concepts such as 'bow-tie analysis' are formally documented with sufficient detail. The plans are approved by the ARC, which questions executive management on what "keeps them awake at night" and ensures there is a process to capture, assess and monitor key risks
A suitably skilled and staffed risk management function is in place	This function ensures the risk management framework and its supporting processes are effective
Improvements to business processes resulting from risk management strategies are captured and measured	Risks are quantified through effective risk indicators, such as reductions in the number of incidents and cost of claims etc
A risk management group captures and monitors risks associated with outsourced activities	This is achieved by obtaining risk reports from service providers that feed into the agency's risk processes

A risk aware culture is an opportunity to protect and create value

Practices employed by agencies assessed to have consistently implemented risk management in the area of Culture are shown below.

Culture	
Better practice	**Example**
The tone from the top supports a well-established risk aware culture across the entity	This is supported by a culture that creates a greater incentive for all staff to acknowledge mistakes and learn from difficulties rather than conceal them. For example, staff face performance management when they knowingly exceed the agency's risk tolerance levels and conceal them. There is a comprehensive risk and compliance breaches register
Risk understanding and tolerance is a key consideration in decision making	Major decisions are endorsed by a risk management group before Board or executive management approval. Key risk indicators are linked to strategic and corporate goals
Risk owners are identified and assigned in the agency's risk register	This provides clear accountability and risk owners are required to report on the status of each risk and related risk treatments
The Board, ARC and executive management lead the development of risk aware culture throughout the organisation	This is demonstrated, for example, by ensuring staff routinely undergo risk management training and assessing the effectiveness of the training as it translates to management practices
The Board and executive management 'walks the talk'	This is demonstrated, for example, by the time devoted to risk management activities and appropriate resourcing of the risk management group

Project Governance

Governance over the delivery of key projects could be improved

The 2014-15 financial audits found that:

- appropriate strategies should be implemented to address risks associated with legacy systems during the transition to new systems. *Volume Six on Transport*
- the Learning Management and Business Reform program costs are likely to be significantly higher than the original business case budget. The final stage of the program's implementation is expected to be deployed three years behind the original timeline. *Volume Eleven on Education and Communities*
- Hunter Water Corporation's capital projects were delivered late but mostly on budget. *Volume Twelve on Water*
- the post implementation review of the LifeLink System identified lessons learned which should be considered in future projects. *Volume Seven on Law and Order*

The NSW Government's 2015-16 budget estimates capital expenditure of $68.6 billion for the four years to 2018-19. There is a commitment of $13.1 billion in 2015-16 for 697 major infrastructure projects.

An effective governance structure to identify, manage and monitor risks associated with significant projects is important to ensure desired outcomes are achieved.

Compliance Management

Compliance frameworks are not effectively managing the risk of non-compliance

Some agencies do not have processes to:

- proactively identify changes to legislation
- assess the risk of non-compliance
- develop strategies to mitigate these risks.

The absence of these processes reduces the effectiveness and potential benefits of a compliance framework. Effective compliance management requires agencies to:

- identify all applicable laws, regulations and government directions
- maintain centralised up-to-date compliance registers
- assign responsibility for each requirement
- monitor and report on compliance.

Some agencies have established comprehensive frameworks to ensure compliance with laws and regulations. Such frameworks are useful tools if updated accurately and in a timely manner. While agencies need to have their own process in place to ensure compliance with specific laws and regulations, a well-designed and managed cluster-wide compliance management framework would provide greater consistency, and clear direction and accountability for compliance management and reporting obligations.

Components of a robust compliance management framework include:

- key policies and procedures to identify, monitor and report compliance obligations
- tools to ensure key compliance obligations are identified and assigned a risk rating, and appropriate mitigation strategies are implemented
- regular reporting to audit and the risk committee on agency compliance with key legislation and regulations, including breaches and actions taken
- an effective communication strategy that ensures the compliance framework is clear and readily accessible to staff members
- regular updates and monitoring of the compliance management framework for relevance.

The diagram below provides an overview of an effective communication strategy within an effective compliance management framework.
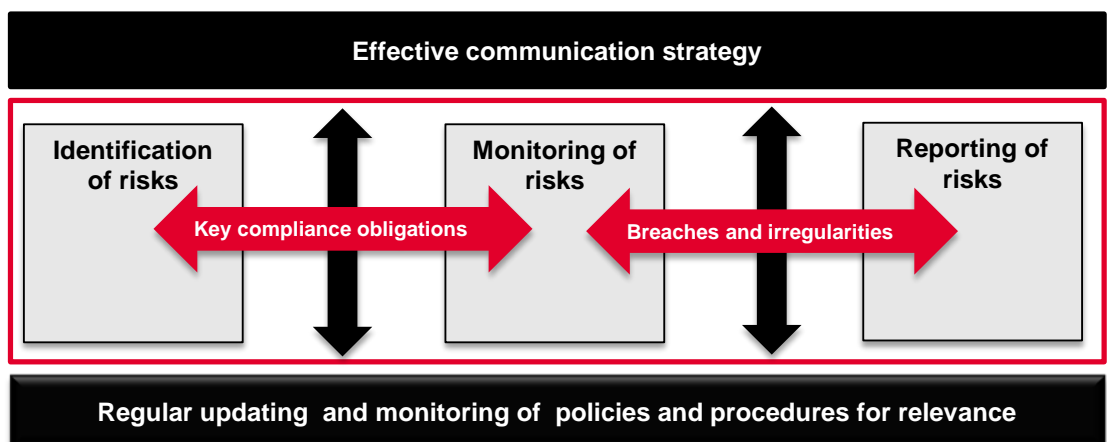
Conflicts of Interests and Gifts and Benefits Registers

Agencies do not have centralised conflicts of interests or gifts and benefits registers

Some agencies do not use centralised registers to record conflicts of interests or gift and benefits. Instead, some rely on minutes of meetings to document such matters, making it difficult to determine if employees are complying with policies and procedures.

The Public Service Commission has outlined the requirements on gifts and benefits, such as policy, register and training.

Service Delivery

The achievement of Government outcomes can be improved through the effective commissioning of the right mix of services from the public, private and not-for-profit sectors.

Commissioning involves the process by which agencies assess their needs, determine priorities, design and source appropriate services, and monitor and evaluate performance.

Service Delivery	
Observation	**Conclusion**
Some agencies self-assessed their contract management processes against the Audit Office's Better Practice Contract Management Framework and identified gaps in their current practices.	Contract management processes can be improved.
Some service level agreements with shared service providers were not finalised on a timely basis.	To achieve desired outcomes and minimise risks, agencies need to finalise and sign service agreements with shared service providers before the agreements commence.
Some agencies did not receive assurance from service providers regarding the effectiveness of controls.	To ensure controls at shared service providers are operating effectively, agencies need to obtain independent assurance that this is so.
Measuring performance in some agencies is poor.	To ensure agencies can make evidence-based decisions and maintain public accountability, some agencies need a stronger focus on measuring performance and outcomes.

Contract Management

Some agencies need to improve contract management processes

The NSW Auditor-General's Report 'Volume One 2015 Areas of focus from 2014' recommended that agencies self-assess their contract management frameworks against the Better Practice Contract Management Framework and address any weaknesses.

Agencies' assessments indicated that:

- most agencies had clear roles and responsibilities for contract management and staff managing the contracts had the appropriate skills and experience
- fewer agencies reviewed the contract management framework
- some agencies did not independently monitor contracts to confirm compliance with service level agreements and identify weaknesses
- while most agencies had policies and procedures to guide staff, some did not have a contract management plan for significant contracts.

A robust contract management framework is vital to help ensure all parties meet their obligations, contractual relationships are well managed, value for money is achieved and deliverables meet the required standards and agreed timeframes.

The NSW Auditor-General's 2014 performance audit 'Making the most of government purchasing power – telecommunication' developed a Better Practice Contract Management Framework with nine key elements.

Most agencies that performed the self-assessment indicated they have reporting and oversight practices for contract management in place, and contract management delegations are clear and consistent with financial delegations.

Variable performance in implementing contestability and contract management

The 2014-15 performance audits observed that:

- the Government is more likely to maximise public value from its investment in vocational education and training (VET) by putting more emphasis on increased contestability and student choice
- bus services provided under the Sydney Metropolitan Bus Service Contracts have largely been effective and efficient, the main exception being punctuality
- the Department of Family and Community Services has put considerable effort into developing the out-of-home care sector and is progressing well towards its goal of transferring all children in statutory care to Non-Government Organisations (NGO)
- the Department of Family and Community Services has worked collaboratively with the community housing industry to enhance the professionalism of the sector.

Shared Services

Agreements with shared service providers were not always finalised in a timely manner

Numerous agencies had not finalised and signed service level agreements with their shared service providers covering 2014-15 before they commenced.

The NSW Commission of Audit, in its May 2012 report on 'Government Expenditure', recommended improvements in the delivery of corporate and shared services across the government sector.

Shared service arrangements are designed to achieve efficiencies and reduce costs by centralising service delivery in areas such as human resources, financial and information technology.

Some agreements with service providers did not have performance measures

Some service level agreements did not have performance measures to monitor the performance of service providers against service level objectives.

Agencies need independent assurance that shared service provider controls are operating effectively

Shared service providers generally issue independent assurance opinions on the operating effectiveness of internal controls to client agencies.

In November 2014, Treasury issued Treasury Policy, TPP14-04 'Certifying the Effectiveness of Internal Controls over Financial Information'. This policy requires agency CFOs to obtain comprehensive letters from service providers to certify the robustness of their control environments for financial reporting. The policy also suggests agencies seek independent assurance opinions from service providers on the design and operating effectiveness of internal controls.

Performance Measurement

Measurement of performance by some agencies is poor

A key objective of public sector reforms is to improve performance and create a culture of accountability. Performance reporting against benchmarks and targets is an effective means of measuring the success of these reforms.

Some agencies in the NSW public sector have limited and inconsistent performance reporting, particularly around financial sustainability. Performance reporting is primarily internal, which reduces transparency and may not meet the information needs of some key stakeholders.

The 2014-15 performance audits found that:

- the Office of State Revenue (OSR) can enhance its performance measures, particularly those around effectiveness and efficiency. Without these measures, it is difficult to determine how the OSR is performing
- the impact of some local and state-wide initiatives on length of stays and unplanned readmissions to some hospitals is not well understood or quantified due to a lack of evaluations
- priorities under the Country Towns Water Supply and Sewerage Program had not been reviewed for a decade, procedures were not well documented and funding conditions were not always enforced. Information management, monitoring and reporting were also found to be poor
- despite its importance, productivity trends in the public sector were not well understood or reported to Parliament
- it was difficult to assess whether overall outcomes for children in care have improved because the Department of Family and Community Services has yet to determine what wellbeing outcomes should be achieved
- it is unclear whether the Department of Family and Community Services has achieved its desired outcomes for tenants, including more flexible, tailored services for tenants and more resilient communities because it did not determine how it would measure these outcomes
- the Department of Trade and Investment, Regional Infrastructure and Services was unable to demonstrate that assistance provided to industry was effective in achieving development objectives. The lack of principles or guidelines on when to give taxpayer money to private businesses for industry development is concerning
- the Department Family and Community Services has not had a strategy for the community housing sector for several years, despite previous reviews recommending a strategy be put in place.

Financial Management Transformation to promote a stronger focus on performance and outcomes management

The Financial Management Transformation program aims to reform existing financial management legislation and the policy framework to promote a stronger focus on performance and outcomes management. The intention is to give the NSW Government and Parliament greater transparency on how public resources are used, and to enable stronger links between planning, budgeting and performance.

Looking Forward

In 2016, the Audit Office will build on its work of 2015 and continue to report financial audit findings across four themes - financial performance and reporting, financial controls, governance and service delivery.

In 2015 financial audit placed greater emphasis on governance by commenting on:

- risk management maturity in some key agencies
- governance arrangements for the ten clusters that make up the NSW public sector
- fraud controls
- compliance management.

This will continue in 2016. More work will be done on risk management in some key government agencies and the Audit Office will review whether government agencies are meeting their public access obligations under the *Government Information (Public Access) Act 2009* for contracts they have with the private sector.

In 2015, performance audits focused on areas of public sector reform by examining:

- productivity in the NSW public sector
- data quality in the health sector
- commissioning of government services in transport, education, and human services
- governance over major capital projects, including reasons for deviations from budget and scope, and how well project assurance is operating.

In 2016, the performance audits will build on topics that target areas of government reform and examine progress against the Government's 30 'State Priorities' including 12 'Premier Priorities'.

Financial and performance audits will collectively focus on:

- financial performance and reporting
  - timely, accurate and reliable public information
  - financial sustainability and budget constraints
- financial controls
  - assessing compliance with government and agency policies, including CFO certification of internal controls
  - information systems for transparent and evidence-based decisions that are secure and fit for purpose
  - workforce flexibility
  - asset management
- governance
  - devolution of decision-making and accountability in clusters
  - collaboration and coordination across agencies and government
  - risk management
  - control frameworks, including fraud and compliance
  - management and oversight
- service delivery
  - performance measurement and reporting, focusing on the Government's 30 'State Priorities' including the 12 'Premier's Priorities'
  - commissioning, including procurement reform, contestability of government services, partnerships and out-sourcing
  - program, project and contract management.

Reform Agenda Better Practice Guides

The Audit Office is working with Treasury, the Department of Premier of Cabinet and the other key NSW Government agencies to develop two better practice guides that will complement areas of government reform. These guides will be published in the second half of 2016 and will draw on the knowledge gained through audits of NSW Government agencies' activities and financial reports.

The first guide on commissioning recognises that Government is increasingly engaging with the private and non-government sectors to provide government services.

The second guide supports the increasingly important role Chief Financial Officers (CFO) play in evidence based decisions that goes beyond financial information to broader information and insight, linking strategy with service delivery.

Commissioning in the public sector

The commissioning guide will include easy to use checklists and case studies that illustrate the important steps and issues that need to be considered when commissioning government services. The guide will help agencies ensure they have the well-designed, structured and understood processes needed for commissioning to succeed in promoting a more competitive and accountable environment, leading to lower costs and improved services.

Extensive consultation with NSW public sector agencies is underway to ensure the guide will be useful to those undertaking commissioning work and to source valuable knowledge and experience in the NSW public sector.

Role of the public sector CFO

The Office's better practice guide on the role of public sector CFOs will complement the work of Treasury's Financial Management Transformation Program.

Treasury's program aims to reform financial management for the NSW public sector. It is a multi-year program to be implemented by 2017-18. The program will revise financial governance arrangements and the budgeting performance framework. It is expected to provide Government with greater transparency and understanding of agency expenditures and performance.

The guide will be very practical and focus on what a contemporary public sector CFO needs to do to deliver value in a changing public environment.

Effective Accountability in New South Wales

The changing nature of government service delivery

All Australian Auditors-General have a mandate to audit the finances and performance of government agencies in their respective jurisdictions, but the way governments operate is changing. Governments are increasingly outsourcing or partnering with the private and NGO sectors to deliver government services.

Many parliaments now have legislation that enables Auditors-General to 'go beyond' the boundaries of the agencies commissioning a service to examine the processes within the organisation providing the service ('follow the money' powers).

This is not the case in New South Wales, where the *Public Finance and Audit Act 1983* has not been significantly amended since its introduction.

The ability to provide an appropriate level of assurance through performance audits is sometimes limited because the Auditor-General does not have a similar mandate to other jurisdictions. In its September 2013 report to Parliament on the Efficiency and Effectiveness of the Audit Office of New South Wales, the Public Accounts Committee recommended the *Public Finance and Audit Act 1983* be amended to enable the Auditor-General to 'follow the dollar' by auditing functions performed by private contractors and other non-government organisations on behalf of the State in the delivery of government programs.

Treasury is currently seeking comments on proposals for the reform of the NSW financial management legislative framework, which includes replacing the:

- *Public Finance and Audit Act 1983*
- *Annual Reports (Departments) Act 1985*
- *Annual Reports (Statutory Bodies) Act 1984*
- *Public Authorities (Financial Arrangements) Act 1987.*

After this initial consultation process, the legislative proposals will be refined before bringing a formal submission for Cabinet's consideration, seeking approval to draft new financial management legislation.

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