



Auditor-General for Australia



24 July 2008

Mr Russell Chafer
Secretary
Joint Committee of Public Accounts and Audit
Parliament House
CANBERRA ACT 2600

Dear Mr Chafer

Attached is the Australian National Audit Office submission to the JCPAA inquiry into the effects of the ongoing efficiency dividend on smaller public sector agencies.

We would be pleased to assist the Committee further with its inquiry. Our contact officer for any initial enquiries you may have regarding the submission is Ms Dianne Rimington (tel: 6203 7744).

Yours sincerely



Ian McPhee

AUSTRALIAN NATIONAL AUDIT OFFICE (ANAO) SUBMISSION TO THE JCPAA INQUIRY INTO THE EFFECTS OF THE ONGOING EFFICIENCY DIVIDEND ON SMALLER PUBLIC SECTOR AGENCIES

Introduction

The efficiency dividend was first introduced in September 1986. When announcing a range of decisions taken by the Government to give effect to their commitment to improve the efficiency of the public sector, the then Prime Minister the Hon R.J.L. Hawke stated that 'the efficiency dividend requirement reflects the Government's view that the benefits of previous measures to improve efficiency and productivity can and should lead to lower costs.' Those measures referred to included establishing an efficiency scrutiny unit to review public sector operations, major changes in the arrangements for the redeployment or retrenchment of inefficient and surplus staff, integration of the job classification arrangements and other management changes designed to make the Public Service more efficient.

Successive Governments have continued to introduce reforms to the public sector and to apply the efficiency dividend. The House of Representatives Standing Committee on Banking, Finance and Public Administration inquiry into the efficiency dividend arrangements "*Stand and Deliver*" (March 1994) noted that the efficiency dividend is the mechanism the Government uses to ensure that a proportion of productivity improvements achieved in the public sector are realised and made available for the Government to allocate according to priorities. It noted that the efficiency dividend was a blunt but effective instrument and recommended its continued application. The Committee also noted there were alternatives to the across-the-board application of the efficiency dividend which offered longer term alternatives to the efficiency dividend (outlined later in this submission) and recommended changes to revenue retention incentives.

There is no doubt that public sector management reforms over the last two decades have resulted in efficiencies being achieved including through the use of flexibility given to agencies to achieve the outcomes required by Government with the resources provided. This has involved agencies seeking to provide the most efficient delivery mechanisms having regard to the costs and benefits of alternative approaches, including the management of price increases and savings opportunities when they arise.

While it is essential that public sector agencies continue to seek efficiencies in the delivery of programs, it is equally important that the efficiency dividend not be a disincentive to the effective delivery of programs by agencies. Today, agencies, particularly smaller agencies, face a range of challenges delivering programs including in meeting required standards; in investing in systems, methodologies and research; in funding market competitive remuneration through productivity offsets; and in creating a work environment which supports the attraction and retention of staff with appropriate qualifications and experience.

Significantly, agencies are also expected to absorb additional demands below nominated thresholds rather than seek additional budget funding, and this has added to the challenge of managing within the resources provided.

It is timely therefore, after more than 20 years of continuous application of the efficiency dividend, to assess the ongoing benefit of this policy.

Inquiry Report points

Whether the efficiency dividend has a disproportionate impact on smaller agencies, including whether or not smaller agencies are disadvantaged by poorer economies of scale or a relative inability to obtain funding for new policy proposals.

Economies of Scale

Larger organisations, by their nature, generally bring the advantage of scale and greater flexibility to be able to reprioritise resource utilisation with less impact on core services. Deriving economies of scale is clearly an issue for small agencies.

Taking audit practices as an example, private sector audit practices generally operate as an integrated business offering not only audit services but commonly tax advice, consultancy services and other related services. Often, these businesses are global or networked. Scale allows specialist resources to be devoted to research and development, auditing methodologies, keeping abreast of the very significant changes in accounting and auditing standards, and undertaking the associated staff training and quality assurance/pier review.

The ANAO is required to have sound policies and practices and support which necessarily must have regard to both professional standards and public sector considerations but without being able to access the efficiencies available to larger audit practices, or invest in any significant way in research and development. To illustrate the growth in professional standards, there has been a 60% increase in page content of accounting standards over the last 10 years and 75% increase in auditing standards page numbers over the same period. Our costs will necessarily be higher, per client, as we have less clients than the major global and networked firms. Significantly though, all of our costs are required to be met from our budget without recovery or supplementation. Similarly, as a small agency, the ANAO is unable to achieve any significant economies of scale in many of its administrative costs, such as professional development of staff and payroll, and is required to meet such costs which have increased over the years from its budget.

The ANAO has just over 300 staff, predominately located in Canberra with a small Sydney office. ANAO operations are largely funded through appropriation (\$63m in 2007-08). Other sources of revenue retained by the ANAO (\$2.3m in 2007-08) are sourced from audit related services, and other minor activities such as sale of assets and rental income from sub-lease of part of our building. In addition, the ANAO receives a Special Appropriation (\$392,000 in 2007-08) to meet remuneration expenses and allowances for the Auditor-General. For these resources, in 2007-08 the ANAO produced 45 performance audit reports, 4 better practices guides and issued 242 financial statement audit opinions.

The impact of the application of the efficiency dividend to ANAO for the 8 year period 2003-04 to 2010-11, \$9.894 m in total, and is outlined in Table 1 below.

Table 1: Effect of Efficiency Dividend

	03-04	04-05	05-06	06-07	07-08	08-09	09-10	10-11
1% efficiency dividend	604	619	637	643	621	636	678	686
0.25% efficiency dividend	0	0	0	0	0*	158	318	481
2% efficiency dividend	0	0	0	0	0*	1,262	1,271	1,280
Total	604	619	637	643	621	2,056	2,267	2,447

* application of Section 50 of the *Auditor-General Act 1997* resulted in the .25% and 2% increase not applying to ANAO until 2008-09

New Policy Proposals

Opportunity to advance New Policy Proposals (NPP) in the budget is available to all Ministers and the agencies in their portfolio. New policy is the opportunity for an agency to obtain additional funding for new work or new programs the Government seeks to implement. The process is well understood by agencies.

Recently, under Department of Finance and Deregulation (DOFD) Estimates Memorandum (EM2007/44) the threshold for major NPPs was increased from \$5 million to \$10 million (over the Budget and forward estimates in the 2008-09 Budget context). All major NPP's (having received prior senior Minister endorsement) are considered by the Expenditure Review Committee (ERC). In order that NPP's that have a financial impact below this threshold be considered by ERC, they must be included as part of a cross-portfolio submission or a package of proposals. Inclusion of such proposals in a cross-portfolio submission is not guaranteed and it is expected that all minor new policy will be offset with savings.

The NPP thresholds (including the recent increase to the thresholds) make it increasingly difficult for small agency proposals to meet the thresholds (due to the general size and cost of proposals in small agencies) or to have small proposals accepted.

ANAO history in seeking additional funding through NPP's is outlined in Attachment A. As the data in the attachment demonstrates, ANAO has had limited opportunity and mixed success with its presentation of NPP's. Many of the NPP's which were unsuccessful relate to the changing nature and the increasing complexity of the audit task, which is core business for the ANAO. Further, in addition to the range of costs mentioned in the previous section, the ANAO has absorbed other costs associated with Government initiatives such as 'green power' (increased cost of electricity of approximately \$300,000 p.a. despite significant investment in measures to achieve more efficient energy consumption) and implementation of government information security requirements involving many components but individually totalling \$730,000. Further, ANAO provides, without supplementation, short and longer term assistance to countries who are seeking to develop appropriate approaches to good governance issues, in particular audit practice and methodology.

The ANAO has also made savings through a variety of initiatives, such as in the areas of telecommunications, records management and IT support functions. However, these savings do not offset the additive effect of the broader range of increases absorbed by ANAO.

Whether the efficiency dividend is now affecting the capacity of smaller agencies to perform core functions or to innovate

As mentioned earlier, the financial reforms in public sector over the last decade have resulted in efficiencies being achieved and it is accepted agencies need to seek the most efficient delivery mechanisms having regard to the costs and benefits of alternative approaches. ANAO ascribes

high priority to managing within resources provided and is alert for efficiencies and means to ameliorate cost pressures.

The ANAO has, for some time, managed a range of cost pressures without material impact on the range and quality of audits undertaken. This has been achieved through a stronger risk based approach to our audit coverage and through winding back support functions that do not have a short term direct front line effect. However, managing cost pressures has become increasingly difficult and ANAO is now at the stage where a reduction in performance audit reports (where there is some discretion) has been necessary in order to maintain quality outcomes.

Professional requirements have increased substantially, not only increasing the audit work effort required but the nature of the work. For example there is a greater use of current cost methodologies to determine asset and liability valuation, now requiring agencies to employ a greater use of valuation and actuarial services. All but 2 of the 17 'material' government agencies use independent experts to assist in determining the value of these items. ANAO internally review the valuation methodologies of all except 5 agencies where experts are used to assist in this audit task. Given the state of world financial markets, our use of experts is likely to increase, placing further pressure on our constrained budget position.

Further, agencies are placing ever increasing reliance on technology to achieve business outcomes. Significant growth and change in the IT environment from relatively simple self contained systems to integrated complex systems supporting multiple programs and agencies has increased the challenge of auditing both new and legacy systems. Data accuracy, integrity, completeness and security are critical audit considerations. IT audit coverage has necessarily been increased due to some internal reallocations of funding. While technical capabilities have been enhanced to a degree and some more audit tools introduced, more could be done to automate auditing tools and apply automated approaches to our audits.

Public administration is becoming more complex and international harmonisation of accounting standards a significant development to respond to and implement domestically. To ensure our auditing practice is progressive and keeps pace with these changes and our reputation as an agency promoting high standards of integrity and accountability of public sector administration maintained, investment in research and development and provision of technical advice to support audit opinion is essential. Our research capacity though is very limited.

As Australia has led the way internationally on adoption of these standards, the ANAO receives many requests from countries seeking assistance either to learn from our experience or to seek help in development and propagation of audit standards, methodologies and technologies. Our capacity to contribute and respond is limited due to resource constraints. Further, because of reduced capacity in the technical accounting service provision area, ANAO is managing demands to respond to accounting and auditing standards exposure drafts through collegiate sharing of the 'lead' response role in the research activity through rotation among the Australian Government and State Audit Offices. The trend has also developed, due to resource constraints, to only comment on the more significant new exposure drafts.

It has also been necessary to reduce the level of auditee/client engagement on developments in standards and their implementation and other reporting and governance developments flowing from Government. The frequency and number of client seminars has reduced from 3 or more per year in 3 capital cities to 1 per year and only in Canberra. While other means are used to disseminate information, there is no substitute for face to face contact in providing clarification

about developments, with the ultimate objective of streamlining the audit task and ensuring shared understanding of the reporting requirements.

What measures small agencies are taking to implement the efficiency dividend and the effect on their functions, performance and staffing arrangements

Effect on functions and performance

It is important to acknowledge that it is the range of cost pressures, as well as the efficiency dividend, that make it challenging for agencies, particularly small agencies, to deliver services to the expected standard. Nevertheless, the effect of the efficiency dividend was foreseen as far back as 1992.

The report "*The Australian Public Service Reformed – An evaluation of a decade of Management Reform*" (December 1992) observed that when considering the efficiency dividend, that some agencies appeared to be attempting to meet the dividend not by productivity measures but by eliminating activities that they could do without. The report noted that those agencies who have depended on this strategy were running out of options and the report also raised the issue of 'dividend evasion' ie that some (perhaps larger) agencies may have learned how to compensate for the efficiency dividend through NPPs. The report observed that if this were true, this could add to the argument that the effectiveness of the current form of the efficiency dividend was 'wearing out'.

The ANAO, for the first time, informed the JCPAA in May 2008 that the level of its current budget has necessitated a reduction in the planned audit program. The effect will be to reduce:

1. the extent of detailed checking in our audits of financial statements of Australian Government agencies; and
2. the number of performance audits and better practice guides ANAO can produce.

This will be achieved, in the performance audit area, by reducing the target number of performance audits from 51 in 2007-08 to 45 in 2008-09 and reducing the target number of Better Practice Guides from 4 in 2007-08 to 3 in 2008-09.

In the assurance audit area, in response to both funding constraints and the need to address the increased demands through changes to accounting and auditing standards, the ANAO is modifying its approach to financial statement assurance work by:

1. looking to a multi-year view for system assurance, where appropriate;
2. placing more reliance on management assurance processes;
3. adjusting its compliance program where it does not directly affect the audit opinion; and
4. limiting any growth in IT audit capacity.

Effect on staffing arrangements

Attraction and retention of a high performing workforce is critical to the success of all agencies. For ANAO, the quality of audit reports and other products relies heavily on the quality of staff and the engagement of experienced contractors. Demand for skills possessed by ANAO staff is high. In a dynamic labour market, particularly for specialist skill areas such as accounting and auditing, it is imperative that long term investment is made in the development of the workforce. ANAO has been and will continue to need to invest in development of staff more than ever before as this is essential to ANAO's long term success and the contribution it can make to good public administration. By way of background, labour related costs represent 70% of total ANAO costs.

The challenges faced by agencies to achieve ongoing productivity gains to offset wage growth continues to put pressure on budgets. The wage cost index (1.8% in 2007-08) applied to agencies funding to reflect cost increases in labour and labour related costs has for some time been well below actual cost movements in the market, which have been running at around 4-5%. In ANAO's case, increases have been reflected in contract auditors costs (contracted in labour rates have increased by 16% over the last 5 years and contract out labour rates are more variable due to the nature of the audit task but at a minimum have increased 5%, others well in excess of that rate of increase). Contract labour represents 50% of our assurance audit costs.

ANAO staff turnover has also been higher in recent years – some 30% in 2007-08 from 20% in 2006-07. As a consequence, ongoing commitment to recruit and train staff in light of turnover puts pressures on ANAO resources. While productivity improvements have been achieved they have not tangibly produced sufficient impact on costs to offset labour cost increases. Another consequence of the turnover rates being experienced by the ANAO is a noticeable reduction in experience. Average workforce tenure has declined (from 6.1 years in 2005 to 5.1 years in 2008), and is lower for audit experience, resulting in a less experienced workforce, which in turn makes it more difficult to achieve efficiencies.

Any impact of the efficiency dividend on the use by smaller agencies of "section 31" agreements to secure non-appropriation receipts (eg through user charges and cost recovery) – noting that these receipts are not subject to the efficiency dividend.

Agencies have responded to the ability to generate small external receipts to supplement their appropriation income, including the ANAO. Recommendations flowing from the House of Representatives Standing Committee on Banking, Finance and Public Administration inquiry into the efficiency dividend arrangements "Stand and Deliver" (March 1994) to exempt these receipts from the efficiency dividend was welcomed by agencies and did result in the identification of alternative avenues for funding. This has, however, been at the margin. Recent changes to the guidance regarding the use of S 31 receipts has placed further caps on receipts able to be retained by agencies.

In ANAO's case, other sources of revenue obtained through S 31 receipts totalled \$2.3m in 2007-08. This represents 1% of the ANAO's revenue.

How the application of the efficiency dividend is affected by factors such as the nature of an agency's work (for example, cultural, scrutiny or regulatory functions) or the degree of discretion in the functions performed by smaller agencies.

Public sector agencies functions are determined either by legislation or government policy. The ANAO has a legislative requirement under the FMA Act, Commonwealth Authorities and Companies Act 1997 and the Auditor-General Act 1997 to audit financial statements of Government controlled bodies. While the ANAO has been able to apply a stronger risk based approach (within the bounds of the auditing standards) to our audit coverage as an aspect of our efficient use of resources, there is no flexibility regarding the number of financial statements to be audited. We have greater flexibility in deciding the number and size of performance audits and better practice guides, but in our view it is not in the long-term interests of Parliament, the Government or the community, for these products to be reduced.

If appropriate, alternative to an across-the-board efficiency dividend to encourage efficiency in the Commonwealth public sector, including consideration of whether certain agencies should be exempted from the efficiency dividend, or whether, the rate of the dividend should vary according to agency size or function.

Both the House of Representatives Standing Committee on Banking, Finance and Public Administration inquiry into the efficiency dividend arrangements "*Stand and Deliver*" (March 1994) and the House of Representatives Standing Committee on Finance and Public Administration on the review of the Financial Management Improvement Program "*Not Dollars Alone*" (September 1990) indicated that very few agencies had been exempt from the application of the efficiency dividend. Evidence given by the then Department of Finance to "*Not Dollars Alone*" indicated that provision had been made for full or partial exemptions from the efficiency dividend where agencies had been subject to recent comprehensive formal review or where application of the dividend would result in unacceptable reduction in quality of service.

Alternatives have been offered to the across-the-board efficiency dividend. The House of Representatives Standing Committee on Banking, Finance and Public Administration inquiry into the efficiency dividend arrangements recommended that alternative approaches such as workplace bargaining, resource agreements, market type approaches, evaluation programs and benchmarking offered a longer term alternative to the efficiency dividend. While the Committee considered the efficiency dividend was effective, it also noted it was a blunt instrument and it was unfair and takes no account of ability to pay.

Based on our enquiries from other audit offices in Australia and in key overseas countries, we are not aware of the application of an efficiency dividend to funding provided by appropriation to any of those offices.

Conclusion

When viewed in isolation, the efficiency dividend is an attractive proposition from a budgetary perspective, recognising that government should be entitled to a dividend from the savings available to agencies for greater flexibility in the administrative arrangements under which they operate; and that the significant level of resources made available from the application of the efficiency dividend may be allocated to other Government priorities. However, the increasing demands on agencies, particularly small agencies, since the efficiency dividend was introduced more than 20 years ago suggest it is time to rethink this policy.

While it was obvious from many of the earlier reforms there were efficiencies, it is much less clear that this position is valid today. As far back as 1992, the report “*The Australian Public Service Reformed – An evaluation of a decade of Management Reform*” indicated that there was an argument that the effectiveness of the current form of the efficiency dividend was ‘wearing out’.

The expectation that agencies will deliver quality services, provide competitive remuneration arrangements and invest for the future, places considerable demands on agencies. In addition, under the current budgetary arrangements, agencies are expected to absorb some additional responsibilities (below nominated thresholds) without supplementation.

The challenge is knowing where the balance lies, in the absence of hard data. It is clear though, that if the efficiency dividend is no longer derived from efficiencies but results in the diminution of services provided by agencies for Government and the community, it is no longer meeting its original policy objective.

As a relatively small agency, the ANAO is reducing its audit coverage in the light of its forward budget position. In our view, this is not in the long-term interests of the Parliament, the Government, or the community. Relief from the efficiency dividend would make a contribution to restoring our forward budget position.

24 July 2008

Attachment A

History of ANAO New Policy Proposals 2004-05 to 2008-09

	04-05 \$m	05-06 \$m	06-07 \$m	07-08 \$m	08-09 \$m	09-10 \$m	10-11 \$m	Total \$m
2008-09 NPPs								
Major Defence Projects funding received				nil	0.750	1.500	1.500	3.750
<i>Original Bid</i>				<i>0.500</i>	<i>1.500</i>	<i>1.500</i>	<i>1.500</i>	<i>5.000</i>
Harmonisation of Government Financial Reporting funding received					nil	nil	nil	nil
<i>Original Bid</i>					<i>1.800</i>	<i>1.400</i>	<i>1.500</i>	<i>4.700</i>
Additional Auditing Work from December AAOs funding received				nil				nil
<i>Original Bid</i>				<i>1.100</i>				<i>1.100</i>
2007-08 NPPs								
Auditing standards – meeting new requirements funding received				2.400	2.400	2.500	2.500	9.800
<i>Original Bid</i>				<i>2.437</i>	<i>2.437</i>	<i>2.437</i>	<i>2.437</i>	<i>9.748</i>
Increased Assistance to Audit Institutions in the Asia Pacific Region funding received				nil	nil	nil	nil	nil
<i>Original Bid</i>				<i>0.932</i>	<i>0.932</i>	<i>0.932</i>	<i>0.932</i>	<i>3.728</i>
2006-07 NPPs								
Major Defence Projects funding received			nil	nil	nil	nil		nil
<i>Original Bid</i>			<i>0.724</i>	<i>0.914</i>	<i>0.970</i>	<i>0.962</i>		<i>3.570</i>
2005-06 NPPs								
Auditing of Aust Government entities funding received		1.100	0.800	0.800	0.800			3.500
<i>Original Bid</i>		<i>1.100</i>	<i>0.800</i>	<i>0.800</i>	<i>0.800</i>			<i>3.500</i>
IT Auditing funding received		nil	nil	nil	nil			nil
<i>Original Bid</i>		<i>0.600</i>	<i>0.600</i>	<i>0.600</i>	<i>0.600</i>			<i>2.400</i>
Defence Auditing funding received		nil	nil	nil	nil			nil
<i>Original Bid</i>		<i>1.000</i>	<i>1.000</i>	<i>1.000</i>	<i>1.000</i>			<i>4.000</i>
Additional Costs Contract- In funding received		nil	nil	nil	nil			nil
<i>Original Bid</i>		<i>0.430</i>	<i>0.430</i>	<i>0.430</i>	<i>0.430</i>			<i>1.720</i>
Additional Costs Contract- Out funding received		nil	nil	nil	nil			nil
<i>Original Bid</i>		<i>1.300</i>	<i>1.300</i>	<i>1.300</i>	<i>1.300</i>			<i>5.200</i>
Auditing of Australian Government entities funding received	3.500	2.300	2.400	2.400				10.600

<i>Original Bid</i>	3.500	2.300	2.400	2.400				10.600
2004-05 Additional Estimates								
IFRS funding received	nil	nil						nil
<i>Original Bid</i>	1.160	1.160						2.320
Department of Human Services funding received	nil	nil	nil	nil				nil
<i>Original Bid</i>	0.150	0.250	0.250	0.250				0.900
2004-05 NPP								
Budget Estimates and Framework Review funding received	2.000	1.700	1.700	1.700				7.100
<i>Original Bid</i>	2.000	1.700	1.700	1.700				7.100
Major Defence Projects funding received	nil	nil	nil	nil				nil
<i>Original Bid</i>	0.700	1.300	1.300	1.300				4.600
Total Successful								34.750
Total Bids								70.186