

Audit Report No. 10

Control Structures as Part of the Audits of Financial Statements of Major Commonwealth Agencies for the Period Ended 30 June 1999

- 3.1 Chapter two discussed the importance of effectively collecting and using financial information. An important precondition for such a process is that the information itself is reliable and timely. Effective control structures provide stakeholders with this assurance.
- 3.2 An agency's control structure is the set of practices that '...provide reasonable assurance that risks are managed to ensure the achievement of the agency's objectives.'¹ An effective control structure can assist with:
- the efficiency and effectiveness of program outcomes;
 - reliable financial reporting; and
 - compliance with laws and regulations.²
- 3.3 This chapter identifies the needs of agencies with respect to control structures. It goes on to outline the findings of the ANAO report. Challenges facing the public sector in establishing effective control structures are discussed, along with the Committee's views on how to meet these challenges.

1 ANAO, 'Defining and establishing control structures', downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

2 ANAO, 'Defining and establishing control structures', downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

Effective control structures

- 3.4 A control structure ‘provides an important linkage between strategic objectives and those functions and tasks undertaken to achieve the objectives.’³
- 3.5 Senior management and the governing body of an organisation are responsible for ensuring that control structures are implemented, effective and regularly monitored and reviewed. For each organisation, it is crucial to ensure that the controls that are implemented are ‘commensurate with the nature of the business’.⁴
- 3.6 The major components of an effective control structure are the following:
- a control environment that reflects a strong commitment by management to establish an effective control structure;
 - effective risk management processes;
 - the regular collection and communication of relevant information; and
 - on-going monitoring and review of the control structure.⁵
- 3.7 An effective control structure can significantly lower the risk of material errors in financial statements produced by the agency. According to the Auditor-General:
- Implementing an effective control structure is an essential responsibility of executive and senior management of an agency. Taken together with their leadership and stewardship roles, these responsibilities represent the three cornerstones of effective corporate governance arrangements concerned with protecting and reinforcing the rights and interests of their various stakeholders.⁶
- 3.8 As part of the need for effective control structures, it is essential that managers have a good understanding of the financial systems in place. Dr Williams from the Department of Defence highlighted this point when he made the following comment on the emerging challenge for all

3 ANAO, ‘Defining and establishing control structures’, downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

4 ANAO, ‘Defining and establishing control structures’, downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

5 ANAO, ‘Defining and establishing control structures’, downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

6 *Audit Report No. 10, 1999-2000*, p. 15.

Commonwealth departments – ‘it is not simply getting the system running but getting managers understanding how to make use of it.’⁷

- 3.9 The Auditor-General also reinforced the need for the dual function of good systems and good management. He raised the following issue in terms of financial reporting and the provision of financial information to managers.

...it is not just the case of putting in place SAP R/3, Finance 1, OLAS, or whatever the system is. It is a question of whether, from a management point of view, we put proper internal control mechanisms around that and not expect that someone else is going to do it.⁸

- 3.10 Effective risk management is an integral part of control structures. When designing appropriate control policies and procedures for managing risk it is important that ‘risks are managed to ensure the achievement of the agency’s objectives’ as opposed to ‘absolute assurance’.⁹ Risk assessment and control activities include ‘identification, analysis and assessment of risks to achieving objectives and the design of control policies and procedures to manage those risks, focussing on those that have potential for more significant exposures and are critical to the business.’¹⁰

- 3.11 In order for management to monitor and review work place performance, regular and relevant information has to come to them. The Committee is concerned that appropriate information is not being provided to managers at various levels throughout Commonwealth departments. Although the information flow is slowing changing, it is important that improvements be made as soon as possible.

- 3.12 It is the Committee’s view that remedial action should be taken by all Commonwealth departments to ensure that relevant financial information is communicated effectively throughout each department. The Committee encourages departments to distribute performance indicators widely, in order to encourage program managers to become more in tune with resource management. The objective is to try to change the mentality and

7 Dr Ian Williams, *Transcript*, p. 18.

8 Auditor-General, *Transcript*, p. 25.

9 ANAO, ‘Defining and establishing control structures’, downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

10 ANAO, ‘Defining and establishing control structures’, downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

get everyone thinking about resource management rather than just the finance and accounting sections.

Control structures in public sector agencies

- 3.13 According to the Auditor-General, the following problems in the areas of Information Technology controls, asset management, accounting systems and controls, Financial management information systems (FMIS), management reporting and financial monitoring ‘...have contributed, in varying degrees, to financial information being unreliable or untimely, thereby hindering management reporting and decision making.’¹¹

Information technology

- 3.14 The ANAO identified the following deficiencies that increase the risk of financial information being compromised:
- FMIS access rights greater than functionally necessary or unauthorised;
 - inadequate review and approval of users’ access to systems; and
 - inadequate segregation of duties and no review or follow-up of control and error logs.¹²
- 3.15 The following examples of inadequate access controls were brought to the Committee’s attention. The ANAO indicated that these inadequate access controls have raised concerns over the protection of data and/or the integrity of the systems. Some of these inadequacies included:
- shared passwords within the department;
 - a number of staff with excessive access privileges; and
 - privileged access to systems needed review.¹³
- 3.16 In addition, the following deficiencies were identified in relation to IT program change controls:
- lack of documented change control procedures; and
 - inadequate review, approval and testing of changes to computer programs.¹⁴

11 *Audit Report No. 10, 1999-2000*, p. 21.

12 *Audit Report No. 10, 1999-2000*, p. 16.

13 *Audit Report No. 10, 1999-2000*, p. 27.

- 3.17 A further example of an inadequate access control was apparent where 'there was no formal FMIS security policy to guide users.'¹⁵ Such inadequate policy measures could increase the risk of breaching approved procedures and therefore could also compromise data integrity.

Asset management

- 3.18 The following deficiencies in asset management could undermine an agency's ability to safeguard and accurately value its assets:
- acquisitions and disposals not recorded in a timely manner; and
 - asset registers not regularly reconciled to financial systems.¹⁶
- 3.19 The ANAO noted that, in the maintenance of the asset register, the following deficiencies have the potential to impact adversely on the reliability of asset records for financial statements purposes:
- incorrect coding of assets;
 - assets disposed of not removed from the asset register; and
 - the asset register not reconciled to the general ledger.¹⁷
- 3.20 Some further examples of identified key financial statement risks include:
- fixed asset revaluations;
 - valuation of assets under construction; and
 - recognition of intangible assets.¹⁸
- 3.21 The above risks were identified by the ANAO as areas most likely to result in material error to the financial statements. The Department of Defence acknowledged these concerns and assured the Committee that they were taking steps to address the issues from both a systems and management perspective. The Committee were told that the Department of Defence faces a big challenge with their large asset base.

14 *Audit Report No. 10, 1999-2000*, p. 17.

15 *Audit Report No. 10, 1999-2000*, p. 36.

16 *Audit Report No. 10, 1999-2000*, p. 17.

17 *Audit Report No. 10, 1999-2000*, p. 29.

18 *Audit Report No. 10, 1999-2000*, p. 30.

...one of the big challenges is our large asset base – obviously the largest asset holder in the Commonwealth – and that presents perhaps a bigger challenge than for some others who are in many respects still more cash based.¹⁹

Accounting systems and controls

3.22 The following deficiencies could jeopardise the reliability of financial information:

- ledger reconciliations not completed adequately or in a timely manner;
- expenditure made without appropriate safeguards; and
- inadequate cash management and debt collection.²⁰

3.23 Some other findings revealed that reconciliations between the financial systems and the then DoFA FIRM (Finance Information on Resource Management) system were not performed and independently reviewed in a timely manner. These reconciliations are similar to bank reconciliations in that they provide assurance over the reliability and integrity of financial information.²¹

3.24 Further examples of inadequate safeguards and controls included 'duplicate vendor master records held on the FMIS. This increases the risk of duplicate payments and potential fraud.'²² One Department's 'receipts of public moneys were not always banked in a timely manner, some being outstanding for between one and eight months.'²³

Financial management information systems

3.25 Many agencies have incurred problems with the implementation of new financial management information systems (FMIS). The ANAO noted that '...a significant number of agencies will encounter difficulties in the preparation of their financial statements as information provided may not be accurate or reliable.'²⁴ The problems are partly due to management underestimating the complexity of the task, combined with a lack of suitable staff and external service providers.²⁵

19 Dr Ian Williams, *Transcript*, p. 18.

20 *Audit Report No. 10, 1999-2000*, pp. 17-18.

21 *Audit Report No. 10, 1999-2000*, p. 29.

22 *Audit Report No. 10, 1999-2000*, p. 37.

23 *Audit Report No. 10, 1999-2000*, p. 35.

24 *Audit Report No. 10, 1999-2000*, p. 19.

25 *Audit Report No. 10, 1999-2000*, p. 19.

- 3.26 Problems that were evident with the FMIS included accounting periods 'not closed off at the end of each month. This allows transactions to be posted to any accounting period in the financial year.'²⁶ It was noted that such problems could adversely impact on the integrity of management reporting of financial information.
- 3.27 The ANAO highlighted the following deficiency's in departmental control structures:
- ...there was a lack of adequate planning for the FMIS implementation. In most instances there were no responsibilities assigned to project activities and no revised timeframe developed for delivering these outcomes after the initial implementation date.²⁷
- 3.28 Another example revealed that 'large journal adjustments have occurred without any record of authorisation or purpose.'²⁸ This lack of access control can lead to the risk of inaccurate account balances and even fraud.

Management reporting and financial monitoring

- 3.29 In 1998-99 the ANAO observed a decline in the quality and timeliness of financial information and monitoring. This in turn, hindered management reporting and decision making. The following factors were identified as contributing to this problem:
- lack of appropriate skills and experience; and
 - difficulties with the implementation of new FMIS's.²⁹
- 3.30 Because of ongoing problems with some functions in the FMIS, reconciliations of departmental ledgers to the then DoFA FIRM system were unable to be completed on a regular basis throughout the year.³⁰

26 *Audit Report No. 10, 1999-2000*, p. 37

27 *Audit Report No. 10, 1999-2000*, p. 37.

28 *Audit Report No. 10, 1999-2000*, p. 51.

29 *Audit Report No. 10, 1999-2000*, p. 20.

30 *Audit Report No. 10, 1999-2000*, p. 34.

Control structures—the way ahead

- 3.31 In order for financial information to be used effectively it is important that effective control structures are implemented and carried out. The Committee identified the following major components for effective control structures:
- a control environment that reflects a strong commitment by management to establish an effective control structure;
 - effective risk management processes;
 - the regular collection and communication of relevant information; and
 - on-going monitoring and review of the control structure.³¹
- 3.32 The following comments and recommendations are intended to improve some of the deficiencies the ANAO highlighted in relation to control structures.

Better practice guides

- 3.33 The ANAO's better practice guide to implementing effective control structures is available on the internet at:
http://www.anao.gov.au/bpg_framework/home.html
- 3.34 The Committee encourages all relevant staff to familiarise themselves with this publication.

Performance agreements

- 3.35 The Committee reiterates its view that the successful implementation of financial reform will depend on a robust system of accountability. The Committee urges agencies to incorporate the achievement of milestones into the performance agreements of relevant staff.

Chief financial officers

- 3.36 The implementation of effective control structures will require a sophisticated understanding of the relevant issues, as well as a high degree of influence within the organisation. The Committee is of the view that all agencies should employ a suitably qualified chief financial officer,

31 ANAO, 'Defining and establishing control structures', downloaded 1 October 1999 (http://www.anao.gov.au/bpg_framework/control3.html)

at an appropriate level of seniority, in the organisation. For some agencies, it may be appropriate to appoint a chief financial officer at the SES level.

Financial Management Information Systems

- 3.37 The Committee noted that most departments had experienced difficulties in implementing and extracting relevant information from the new financial systems. The Committee urges all agencies to have a fully operational financial system in place as soon as possible. This will in turn provide management with relevant and accurate information in a timely manner.

Information technology

- 3.38 The ANAO highlighted several examples of system access rights that were greater than functionally necessary, or even at times unauthorised. In view of these inadequate access controls, the Committee makes the following recommendation.

Recommendation 3

- 3.39 **The Committee recommends that agencies define and restrict access rights to certain persons at particular levels for information technology systems.**

Effective communication of changes

- 3.40 While expertise at the executive level is critical, it is also important that any changes, and the reasons behind them, are communicated effectively to all staff. Ownership of, and adherence to, any new procedures will be higher if staff understand and support the reasons for their introduction.

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Chairman
31 May 2000