

Adding More Value: Maximising the Benefits of Internal Audit for Local Government

1. Introduction

Requirements for internal audit in Australian local government are relatively recent, beginning around 2005.¹ From the outset, both legislators and practitioners drew heavily on approaches developed in state and federal public services and the private sector. Until recently, the focus has been squarely on what might be termed ‘conventional’ functions of internal audit around risk, financial management and sound corporate governance. But the intended scope of internal audit in local government now appears to be widening to address other elements of the performance and accountability of councils as democratic, elected bodies serving local communities.

Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations. (Australian Institute of Internal Auditors)²

Whilst the Act requires that Councils establish an Audit & Risk Committee, the key driver for doing so should be to support Council to discharge its responsibilities in complex areas ... The appointment of independent members to the Committee as outlined in this Charter enables the Committee to provide advice to Council ... based on broader skills and experience than might otherwise be the case and in so doing bring additional benefits to Council. (Victoria Audit and Risk Committee Charter)³

This paper builds on that apparent shift in thinking, and without claiming to provide a comprehensive analysis, it explores opportunities for a more ‘creative’ approach to internal audit, rather than it being seen as another box to be ticked or a further layer of inspection. In particular, the paper considers the varied ways in which internal audit can be scoped and implemented, including placing more emphasis on improvement, self-regulation and community-focused governance.

Defining ‘Internal Audit’

A distinction needs to be drawn between the role of an Audit (or ‘Audit and Risk’ or ‘Audit, Risk and Improvement’) Committee⁴ on the one hand, and the formally defined ‘Internal Audit’ function on the other. Current or proposed legislation in most states requires the audit committee to monitor and provide advice on a very broad range of issues. These are statutory requirements that councils must observe, but not every responsibility of the audit committee has to become a task for the internal audit function or the nominated internal auditor. For example, an audit committee may work directly with management to consider progress in implementing strategic plans or service reviews; or liaise directly with the Auditor General’s office to follow-up the findings of an external financial or performance audit.

For the purposes of this paper ‘internal audit’ is defined as the *potential* range of activities that could flow from the legislated role of the audit committee.

¹ Robyn Pilcher. ‘Role of Internal Audit in Australian Local Government Governance: A Step in the Right Direction.’ *Financial Accountability & Management*, 30(2), May 2014

² https://iia.org.au/sf_docs/default-source/quality/internalauditinaustralia.pdf?sfvrsn=2&submission=398357332

³ <https://engage.vic.gov.au/index.php?CID=3458>

⁴ Throughout this report the term ‘audit committee’ is used to cover all three options.

2. Recent Developments

Given its potentially broad scope, there can be no uniformly ‘right’ way to structure and implement internal audit. Across Australia, there are significant differences in legislative provisions and guidelines from state to state, as well as in practice from council to council.

All state local government Acts include provisions for the establishment and operation of audit committees, plus in most cases an internal audit function – although the precise scope and structure of the latter may not be clearly defined. By way of example, Table 1 summarises current legislative provisions in New South Wales, Victoria and Queensland. NSW and Victoria now envisage a very broad scope of operations for audit committees, including financial management, legislative compliance, risk management, fraud prevention, performance monitoring, continuous improvement, and various other aspects of ‘good governance’. The audit committee provisions of the South Australia *Statutes Amendment (Local Government Review) Bill 2020*⁵ follow a similar path.

Queensland and Western Australia⁶ take a more conservative approach. The Queensland Local Government Regulation refers specifically to ‘internal audit’ and focuses on ‘operational risks’. However, such risks can be broadly defined, and the internal audit plan may cover a wider range of issues. This is made clear in associated guidance provided by the Queensland Department of Local Government.⁷ In Western Australia, Operational Guidelines issued in 2019 suggest that the audit committee’s primary roles are to take responsibility for the annual external audit, and to review and advise the council on matters relating to effective management of financial and other risks; protection of council assets; compliance with laws, regulations and relevant best practice guidelines; and coordinating internal and external audit.

New South Wales	Victoria	Queensland
<p>Section 428A Audit, Risk and Improvement Committee</p> <p>(1) A council must appoint an Audit, Risk and Improvement Committee.</p> <p>(2) The Committee must keep under review the following aspects of the council’s operations:</p> <ul style="list-style-type: none"> (a) compliance, (b) risk management, (c) fraud control, (d) financial management, (e) governance, (f) implementation of the strategic plan, delivery program and strategies, (g) service reviews, (h) collection of performance measurement data by the 	<p>Section 54 Audit and Risk Committee Charter</p> <p>(1) A Council must prepare and approve an Audit and risk Committee Charter.</p> <p>(2) The Charter must specify the functions and responsibilities of the Committee including the following—</p> <ul style="list-style-type: none"> (a) monitor the compliance of Council policies and procedures with (i) the overarching governance principles; (ii) this Act and the regulations and any Ministerial directions; (b) monitor financial and performance reporting; (c) monitor and provide advice on risk management 	<p>Regulation 207 Internal Audit</p> <p>(1) For each financial year, a local government must—</p> <ul style="list-style-type: none"> (a) prepare an internal audit plan; (b) carry out an internal audit; (c) prepare a progress report for the internal audit; (d) assess compliance with the internal audit plan. <p>(2) An internal audit plan includes statements about—</p> <ul style="list-style-type: none"> (a) the way in which the operational risks have been evaluated; (b) the most significant operational risks identified from the evaluation; (c) the control measures that the local government has

⁵[https://legislation.sa.gov.au/LZ/B/CURRENT/STATUTES%20AMENDMENT%20\(Local%20Government%20Review\)%20Bill%202020/D_AS%20RECEIVED%20IN%20LC/STATUTES%20GOVERNMENT%20REVIEW%20BILL%202020.UN.PDF](https://legislation.sa.gov.au/LZ/B/CURRENT/STATUTES%20AMENDMENT%20(Local%20Government%20Review)%20Bill%202020/D_AS%20RECEIVED%20IN%20LC/STATUTES%20GOVERNMENT%20REVIEW%20BILL%202020.UN.PDF)

⁶ https://www.dlgsc.wa.gov.au/docs/default-source/local-government/operational-guidelines/operational-guideline-9-the-appointment-function-and-responsibilities-of-audit-committees.pdf?sfvrsn=77bf5a06_1

⁷ <https://www.dlgrma.qld.gov.au/local-government/finance/annual-financial-reporting/internal-audit-and-audit-committees.html>

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<p>council, (i) any other matters prescribed by the regulations.</p> <p>a. The Committee is also to provide information to the council for the purpose of improving the council’s performance of its functions.</p> <p>Section 8A Guiding Principles (edited)</p> <ul style="list-style-type: none"> • Strong and effective representation, leadership, planning and decision-making • Best possible value for residents and ratepayers • Plan strategically to meet the diverse needs of the local community, and to achieve desired outcomes and continuous improvements. • Work co-operatively with other councils, the State government and others to secure appropriate services • Act fairly, ethically and without bias • Transparent and accountable decision-making to meet diverse needs, and to advance social justice and ecologically sustainable development • Actively engage with local communities through integrated planning and reporting and other measures. 	<p>and fraud prevention systems and controls; (d) oversee internal and external audit functions.</p> <p>(3) An Audit and Risk Committee must adopt an annual work program.</p> <p>s9. Overarching Governance Principles (edited)</p> <ul style="list-style-type: none"> • Make decisions in accordance with the relevant law • Give priority to achieving the best outcomes for the community, including future generations • Promote the economic, social and environmental sustainability of the district • Engage the community in strategic planning and strategic decision making; • Pursue innovation and continuous improvement • Collaborate with other councils, governments and statutory bodies • Ensure the ongoing financial viability of the council • Take into account regional, state and national plans and policies • Ensure the transparency of decisions, actions and information. 	<p>adopted, or is to adopt, to manage [those] risks.</p> <p>(3) A local government must give its audit committee—</p> <ul style="list-style-type: none"> (a) the progress report mentioned in subsection (1) (c); and (b) at least twice during the year after the internal audit is carried out, a summary of (i) the recommendations stated in the report; (ii) the actions that have been taken by the local government in response to the recommendations; (iii) any actions that have not been taken by the local government in response to the recommendations. <p>Section 4 Local Government Principles (edited)</p> <ul style="list-style-type: none"> • Transparent and effective processes, and decision-making in the public interest • Sustainable development and management of assets and infrastructure, and delivery of effective services • Democratic representation, social inclusion and meaningful community engagement • Good governance of, and by, local government • Ethical and legal behaviour of councillors and employees.
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The new provisions for Audit, Risk and Improvement Committees (ARICs) in NSW were legislated in late 2016, but have yet to become mandatory. They are now expected to be introduced progressively over the period 2022-26, initially with a strong focus on risk management and compliance, and later expanding into the new areas of strategic planning, performance monitoring and service reviews. Many councils have already implemented them to some extent, notably by establishing an ARIC with an expanded remit.

Victoria’s approach was updated through the completely re-written local government Act in mid-2020. The shift in thinking to a broader concept of internal audit is particularly evident in the way the Act makes the Audit and Risk Committee responsible for monitoring compliance with the new ‘overarching governance principles’, thus extending its remit to matters such as transparency of decision-making, community engagement, inter-generational equity, environmental sustainability and collaboration with other councils and government agencies. The NSW and Queensland Acts set out similar guiding principles, and there is evident potential for internal audit processes to explore the extent to which those principles are being observed.

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In most states the legislation and/or policy guidelines also make explicit the increasingly important linkage between internal and external audit. The importance of this relationship has been highlighted by all states except South Australia making the Auditor General responsible for local government audits, and in particular by the extension of that role into performance auditing. The latter means that Auditors General now provide information and analysis, and may make recommendations for improvement, across a wide range of local government functions, including strategic planning, service delivery and performance monitoring. Mechanisms are needed to translate those findings into council practices, and to ensure that specific recommendations are followed-up: audit committees and the internal audit function surely have an important role to play.

3. Scoping Internal Audit

All jurisdictions require audit committees to endorse and oversee audit plans – including internal audit functions. In light of the potentially very broad scope of internal audit now identified in legislation, and the limited resources available for this function, questions of balance and priorities loom large. What package of internal audit activities might add the most value to a council's operations – and to the community that the council serves?

With that question in mind, the following sections review current and potential internal audit functions under four broad headings: risk, compliance and probity; financial management; performance monitoring and improvement; and community-focused governance.

3.1 Risk, Compliance and Probity

Management of risk, together with appropriate internal controls and processes to ensure legislative compliance, probity and sound corporate governance, remain essential elements of internal audit. Indeed, the NSW government's 2019 discussion paper on implementation of the 2016 amendments to the local government Act was actually titled *A New Risk Management and Internal Audit Framework*.⁸

Properly conceived, risk management can and should be a value-adding process, not only finding solutions to actual or potential problems but also identifying opportunities that can be grasped by taking calculated risks. There can be a tendency, however, for policy and practice to over-emphasise constructing 'defences' against risks and adopting an overly cautious approach that inhibits innovation and results in lost opportunities. Clearly, this would run counter to exploring a more 'creative' approach.

A related issue when scoping internal audit is the common perception that local government is prone to misconduct, fraud, corruption and poor financial management. Real or perceived failings on the part of both councillors and local government managers attract considerable attention from disgruntled constituents, the media and state politicians, resulting in calls for increased scrutiny, regulation and intervention by state agencies, ombudsmen and corruption commissions. For example, the 2019 Australian Leadership Index⁹ indicated that local government needs to improve perceptions of its performance with respect to accountability, ethics and transparency. Also, the NSW Independent Commission Against Corruption (ICAC) recently outlined the role public sector audit committees should play in addressing the risk of fraud and corruption.¹⁰ This should be focused

⁸ NSW Office of Local Government (2019) *A New Risk Management and Internal Audit Framework: Discussion Paper*

⁹ See <https://www.australianleadershipindex.org>

¹⁰ <https://www.icac.nsw.gov.au/prevention/corruption-prevention-publications/latest-corruption-prevention-publications/dealing-with-corruption-fraud-and-the-icac-the-role-of-public-sector-audit-and-risk-committees>

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on promoting an ethical culture by advising on better practice and proactively challenging the organisation to improve – but certainly not crossing the line into management.

These are undoubtedly important issues for consideration when scoping internal audit programs. Again, however, care should be taken to ensure that giving due attention to preventing fraud and corruption does not produce a regime of excessive control and inspection that magnifies under-performance rather than achievement, and in which costs outweigh benefits.¹¹ Local government is already subject to extensive external scrutiny and resources for internal audit may be better utilised on other priorities.

3.2 Financial Management

Monitoring and review of a council's financial management is another cornerstone of internal audit. As many councils grapple with the mismatch between community needs and demands for infrastructure and services on the one hand, and limited resources on the other, effective and appropriate use of available funding is essential. This challenge is again being highlighted by the need for councils to recover from the adverse fiscal impacts of the COVID-19 epidemic.

As discussed in section 2, audit committees are commonly tasked with monitoring and (ideally) linking internal and external audit, which in most states now involves managing the relationship with the state Auditor General, who will expect his or her findings and recommendations to be pursued rigorously. That may also involve cross-referencing both financial and performance audits.

A further element of the expanding remit of audit committees in financial management is the potential for increased self-regulation by councils. The Tasmanian state government¹² recently abandoned a proposal for oversight of council rates increases by the Tasmanian Economic Regulator, announcing instead that the chair of a council's Audit Panel will review any proposed changes to rates that deviate from its Long Term Financial Plan. Similarly, the May 2020 report of the Western Australia Local Government Review Panel proposed using new Audit, Risk and Improvement Committees as a vehicle for self-regulation, notably in setting fees and charges.¹³

3.3 Strategic Planning, Performance Monitoring and Improvement

In several states audit committees are now expected to monitor processes and outcomes of strategic and corporate planning, service reviews and performance measurement and improvement. This was the key change made in the 2016 amendments to the NSW Act. It is also inherent in the provisions of the new Victorian Act and the current South Australian Bill.

Various forms of performance monitoring and reporting are commonplace across Australia. They include:

- Reporting by all councils against a standard set of key performance indicators imposed or authorised by the state government
- Performance audits of individual councils or the local government sector as a whole conducted by a state agency – usually the Auditor General in the case of sector-wide audits
- Reporting by individual councils against performance targets and objectives set out in strategic and corporate plans (required in some form in all states).

¹¹ Pilcher op. cit. p.213

¹² See http://www.dpac.tas.gov.au/divisions/local_government/local_government_legislation_review2

¹³ Final Report available at <https://www.dlgsc.wa.gov.au/department/publications/publication/local-government-review-panel-final-report>

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A great deal of information is being collected that can be used to benchmark the performance of councils against similar counterparts, whether across-the-board or in specific areas of service delivery or governance. This information can subsequently form the basis for programs or projects to bring about required improvements. The issue that then arises is how the collection, verification and use of data is to be overseen: what balance should be struck between on the one hand, 'top-down' systems managed by state agencies; and on the other, 'bottom-up' processes managed by councils themselves, perhaps as an explicit function of internal audit.

As noted in Table 1, NSW and Victoria already identify an important role for audit committees in this area. The Western Australia Local Government Review Panel strongly favoured a similar approach. Audit committees that have a majority of independent, expert members can help ensure that performance monitoring and improvement systems are well designed and managed, properly address important issues of concern to the elected council and the local community, and are effectively implemented. This role can extend to specific service reviews, as proposed in NSW.

3.4 Community-focused Governance and Accountability

All elements of internal audit are concerned in some way with the quality of governance. But the challenge posed by recent legislation, especially the requirements for performance monitoring and reporting discussed above, as well as those for strategic planning, service reviews and closer engagement with the community and key stakeholders, is to move beyond a model that is largely inward-looking, to one that ensures local councils work more effectively as democratic entities. They need to adapt to changing community needs, be more accountable for their actions, and play a stronger role as a partner in Australia's system of government.

The guiding principles now being incorporated in local government Acts blend established thinking about sound *corporate* governance (meeting statutory requirements, ethical administration, accountable and transparent decision making, handling complaints etc) with newer concepts of *community* governance (robust local democracy, active citizenship, community engagement and so on). One is primarily focused on the council organisation, the other on its external relationships, especially its citizens and electors. 'Good governance' should combine the two, with meaningful accountability to the local community as a primary goal.

This last point was highlighted in the recent report of the WA Local Government Review Panel, which flagged a new role for internal audit in ensuring effective accountability of councils *locally* as an alternative to excessive state oversight. Hence its proposals for ARICs with a majority of independent members, an independent chair, and a responsibility to report publicly through council and community meetings, as well as a dedicated section of the council's annual report.¹⁴

4. Relationships and Resources

State legislation and policies are already locking-in significant changes to the future scope of internal audit. As noted earlier, for example, the NSW government has set a timetable for ARICs to assume an expanded role. So it is timely to consider how those changes could affect the way internal audit functions are structured and resourced, as well as working relationships amongst the key players.

Firstly, there is now widespread (but by no means unanimous) agreement that audit committees should have a majority of independent members with relevant expertise, an independent chair, and also include elected councillors but NOT the chief executive (at least not as a voting member). Also, it

¹⁴ *ibid*, p.40

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is typically proposed that the committee consist of 5-7 members, of which 3-5 would be independent experts. This broad consensus raises several important questions:

- **As the potential scope of internal audit expands, will 3-5 expert members be sufficient to cover all the complex issues that might be referred to the audit committee?** If the answer is 'no', one option might be for a group of councils to establish complementary reference groups for those issues such as strategic planning, performance monitoring and service reviews that would benefit considerably from comparative analysis.
- **What is the role of the committee chair?** It seems likely that the role and status of the chair will be enhanced together with that of the committee, especially if audit committees are used as a tool for self-regulation, as proposed in Tasmania and Western Australia, and if internal audit becomes more outward-facing in order to strengthen councils' accountability to their local communities. In the proposed Western Australian model, the chair could become a significant public figure. More conventionally, he or she might also become the pivotal link with state Auditors General in the conduct of external financial and performance audits. Committee chairs need a breadth of skills and experience – and the right personality – to play these roles well.
- **Is there a special role for the mayor?** Increasingly, local government Acts see mayors as exercising leadership in strategic and corporate planning, in community engagement, in fostering productive partnerships with key stakeholders, and in inter-government relations. There is an evident fit between those responsibilities and potential emerging elements of internal audit, as well as that between the more conventional functions of internal audit and the mayor's overarching duty to ensure good governance. This suggests a case for the mayor to be an *ex officio* member of the audit committee, facilitating a close working relationship with the elected body, ensuring timely reports to councillors, and liaising with the committee chair on key issues.

Secondly, an expanded role for audit committees as a mechanism for accountability and self-regulation would highlight the need to ensure their freedom from unwarranted interference or restriction by the elected council and senior management. Sometimes both the internal audit function and the audit committee are heavily influenced by the chief executive (for example, through selective provision of resources, or lines of reporting), creating significant potential for conflicts of interest.¹⁵ This can be addressed by empowering the committee to report directly to the elected council whenever it wishes to do so; enabling the internal auditor to meet with the committee without the chief executive being present; or by making another senior officer (a 'chief audit executive') responsible for working with the committee and ensuring that it receives adequate administrative support. In some states, the provisions of local government Acts may need to be amended to enable a fresh approach. However, in the final analysis maintaining trust and productive working relationships amongst the key players – the committee chair, the mayor, the chief executive and the internal auditor (or chief audit executive) is the paramount consideration, and each must respect the role and prerogative of others.

Thirdly, internal audit must be adequately resourced. Historically, all forms of audit in local government have been under-funded, largely due to competing priorities but perhaps also because the value of constructive – not merely regulatory – audits that point the way to better outcomes was not understood. Nevertheless, the fact remains that in the great majority of councils resources are scarce relative to needs. Any moves to expand internal audit and the role of audit committees will therefore have to be phased-in over an extended period, as proposed in NSW. By the same token, however, councils would do well to consider:

- whether limited resources for internal audit are being used to the greatest effect and allocated to audit functions that will make a real difference to community outcomes; and

¹⁵ NSW Independent Local Government Review Panel (2013) *Final Report: Revitalising Local Government*, p. 56

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- whether it is possible to build an element of performance monitoring and improvement into ‘mainstream’ projects and programs, with the results submitted to the audit committee for review – this approach may provide an additional avenue of funding for internal audit projects.

5. Conclusion

Likely futures for internal audit are already becoming clear through the passage of new or amended legislation in several states. The remit of audit committees and the scope of internal audit is set to expand. Moreover, the mix of functions *and priorities* appears certain to change significantly with the emergence of a distinctive approach to internal audit attuned to the particular characteristics of local government – especially its complex relationships with state governments the one hand, and diverse local communities on the other.

More wide-ranging internal audit, centred on more independent and authoritative audit committees, offers the potential to enhance both the operations and status of local government. As Victoria’s Audit and Risk Committee Charter suggests, with the right mix of members audit committees can provide advice to both management and the elected council based on broader skills and experience than might otherwise be available from within the organisation.

At the same time, internal audit can ‘shift the dial’ towards improvement and added value. This does not mean abandoning attention to risk, compliance, probity and financial management, but room has to be made for activities such as reviewing the adequacy and implementation of strategic and corporate plans, performance monitoring and continuous improvement programs, and the outcomes of service reviews. What are now ‘audit plans’ may become ‘audit and improvement’ plans, and additional resources will have to be found, or priorities adjusted within existing budgets, to fund the tasks involved.

As internal audit continues to evolve, the overarching goal should be to present a balanced picture of councils’ performance that identifies both weaknesses and strengths, whilst pointing to avenues of improvement. Despite its inevitable failings, the value of democratic local government as a principal means to enhance quality of life and place needs to be enlarged, not repeatedly questioned. Internal audit can play an increasingly important role in that endeavour: now is the time for councils – individually or in groups – to consider how best to realise its potential and prepare for the changes ahead.

About the Author

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