Local council governance and audit committees - the missing link?

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Abstract
Purpose: To examine the level of compliance of NSW Local Government councils with the Internal Audit Guidelines developed and published by the NSW State Government to address the identified weaknesses in the governance structures of the councils. The specific focus in this paper is on a key component of good governance, an audit committee, and whether the NSW Local Government councils have followed the guidelines and established an audit committee. Design / methodology: This paper is based on archival research of the 2009/2010 Annual Reports and websites of NSW Local Government councils to collect data on the existence and structure of their audit committees. The data is presented and analysed using basic quantitative analysis from which inferences are drawn. Findings: There is only minimal following by NSW Local Councils of the Internal Audit Guidelines provided by the NSW State Government in relation to the establishment of an audit committee. The audit committees, which have been established, were reviewed and the structure and membership of a number of these committees were found to not meet the level of independence required as outlined in the guidelines. Practical implications: This paper highlights the risk Local Government councils expose residents of NSW and the NSW State Government to due to a significant omission by the majority of NSW councils in not implementing a key component of good governance, an audit committee. The findings indicate the current position of the State Government to only provide recommendations through the Internal Audit Guidelines to establish an audit committee, rather than legislate is insufficient. Originality / value: While there is a relatively large amount of literature on Local Government practices there is little on the level of compliance of Local Government councils with specific governance requirements such as the establishment of an audit committee.

Keywords
governance, council, committees, local, audit, missing, link

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Local Council Governance and Audit Committees - The missing Link?

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Abstract

Purpose – This paper examines the level of compliance of NSW Local Government councils with the Internal Audit Guidelines developed and published by the NSW State Government to address the identified weaknesses in the governance structures of the councils. The specific focus is on a key component of good governance, in this instance whether an audit committee was established in accordance with the guidelines.

Design / methodology – Archival data was used to research the 2009/2010 Annual Reports and websites of NSW Local Government councils to collect data on the existence and structure of their audit committees. The data is presented and analysed using basic quantitative analysis from which inferences are drawn.

Findings – There is only minimal compliance by NSW Local Councils to the Internal Audit Guidelines in relation to the establishment of an audit committee. The audit committees, which have been established, were reviewed and the structure and membership of a number of these committees were found to not meet the level of independence required as outlined in the guidelines.

Practical implications – This paper highlights the potential risk exposure in Local Government councils. The findings indicate that the current approach of merely recommending the establishment of an audit committee, is not as robust as legislation.

Originality / value - While there is a relatively large amount of literature on Local Government practices there is little on the level of compliance of Local Government councils with specific governance requirements such as the establishment of an audit committee.

Keywords: Audit committees, corporate governance, internal audit.

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Introduction

This paper will explore the level of compliance of NSW Local Government councils with the Internal Audit Guidelines (2010) provided by the NSW State Government. The paper is broken into four separate sections. The first will outline the structure of Local Government Councils including their role and the impact of the recent reforms to make the councils more effective and accountable. Following this discussion the paper covers corporate governance and two key components of an effective corporate governance structure, internal audit and audit committees. The fourth section includes the research data collected, and discussion on the results and the implications of these results on the standard of governance in NSW Local Councils. The following section introduces Local Government Councils.

Local Government Councils

Within Australia there are three levels of government, there are Federal and State Governments and Local Councils (Boon, Crowe, McKinnon & Ross 2005), with elected representatives at each of these levels. The Federal and State governments have their authority enshrined in the Constitution Act of 1900 (Burritt & Welch 1997) ensuring their power and capacity to govern. However Local Councils were not mentioned in the constitution and their power to operate is derived from their respective State Governments, additionally due to their limited capacity to generate revenues Local Councils are reliant on State and Federal funding to carry out their responsibilities. Arguable due to their close community links Local Councils may be the most aware of their respective local and regional issues and are potentially the “most sensitive to” community interests, however due to insufficient availability of resources and lack of constitutional authority they have been “relegated to a subordinate role” (Stilwell & Troy 2000, p.909). This is evident where on occasions State Governments have removed the elected representatives and installed administrators to manage particular councils.

While Local Councils are heavily reliant on Federal and State Government funding prior research indicates there are only “low levels of accountability and very little performance measurement taking place” (Kloot 2006, p 565) contributing to the discharge of the Local Councils’ accountability. However, recent changes “have been imposed on the sector, enhancing local and central accountability, making it more business-like” (Kloot 2006, p 565). While the emphasis of these changes has been on the financial and budgetary measures for financial accountability, the performance of programs and people are both being measured. The expanding regulation of Local Councils has continued to increase the need for disclosure in a wide range of areas (Gray 2001). These regulations and reliance on funding from State and Federal Governments impose duties on Local Councils to be accountable and provide reports and information to meet both the regulatory requirements of State and Federal Governments, and to address the needs of a variety of other stakeholders. Accountability is seen as essential as councils manage public monies and they have a fiduciary responsibility to protect public money and assets (NSW Trustees Act 1925) as well as to the responsible manage those funds for the benefits of all their stakeholders.

Local Government Councils within Australia have been for a great deal of time perceived as inefficient and unable to manage the commercial elements of their operations and proposals were made that they should adopt a more business style approach. Community concerns were continually raised about the quality and comparability of public-sector external reports, questioning both the efficiency and the effectiveness of the public sector. These concerns have resulted in demands from the public for additional information on how governments spent public funds (Kent 2003). By the late 1970’s due to the absence of specific standards for the public sector the Commonwealth and State Auditor-Generals
began to apply private-sector standards to the public-sector (Chua & Sinclair, 1994). To address efficiency problems experienced by councils, and in particular the smaller councils, the reforms associated with financial reporting requirements resulted in a focus on identifying and reporting on key performance measures on a financial year basis (Jones & Bowrey 2010). The rationale for these financial reforms was that they would improve the usefulness of the information reported for decision making and also enhance accountability (Carnegie 2005) as well as address the efficiency concerns of some councils. In 1988 when Nick Greiner was elected premier of NSW one of his pledges was that he would reform and enhance government efficiency by taking a business-like approach (Barton 2005). Acting on the advice from US based consultants, he adopted existing accounting rules from the private sector to avoid “wasting time by reinventing the wheel” (Christensen 2003). Christensen noted that “there was a zealous belief (by the consulting firms) that bringing public sector accounting into line with private sector accounting was an inherently righteous objective’ (2003, p. 1). In terms of Local Government this indicated that the approach would be to focus more on being profitable, reducing expenditures and being more accountable for their actions. A key financial reform was the implementation of accrual accounting in 1993 which replaced the previous cash based approach (Laing 2007).

The legislative reforms enacted during the 1990s with the purpose of improving efficiency, effectiveness, accountability (Guthrie 1998; Barton, 2005) and transparency, while enhancing productivity and competitiveness of the public sector (Boxall 1998) have had the effect, according to Dollery, Wallis and Allan (2006), of empowering local government with “greater flexibility to change both the way in which it operates and the range of services that it provides” (p 555). The purpose of Local Government Councils is to provide a wide range of services (Laing 2007) to their community however “community expectations of local government seem to have increased and higher tiers of government have simultaneously devolved various new functions to local authorities” (Dollery et al 2006, p 555). Resulting in local authorities providing a wider range of services and moving away from their traditional narrow emphasis of providers of services to property and people (Dollery et al 2006) such as maintenance of roads, water supply and waste removal. The expectations imposed on councils now include responsibility for many social issues such as “health, alcohol and drug problems, community safety and improved planning and accessibility transport” as well as being increasingly more active in the application and monitoring of regulation in relation to “development and planning, public health and environmental management” (Dollery et al 2006, p 555).

The following section provides an overview of corporate governance which when implemented appropriately in a Local Government Council will contribute to assisting the council meet it operational and financial responsibilities.

Corporate Governance

Corporate governance is the system by which organisations are directed, controlled, and held to account (ANAO 2003; ASX 2003; O’Regan et al 2005) and “encompasses authority, accountability, stewardship, leadership ... in the organization” (ANAO 2003a, p 6). Uhrig (2003) explained that corporate governance is concerned with “the power of those in control of the strategy and direction of an entity ... taking into account risk and the environment in which it is operating” (p 2). The focus in recent times on corporate governance has been mainly on the impact of poor corporate governance leading to organisations collapsing such as OneTel, Harris Scarfe and HIH (Leung & Cooper 2003) and more recently ABC Learning. These events have led to increased interest “regulatory and other responses to improving corporate governance in the private sector” (ANAO 2003a, p 6). While the attention of corporate governance has been primarily on private sector organisations it is equally important for public sector organisations to have strong corporate governance structures. The performance, roles and responsibilities of the
governance structures of both the public and private sectors have a number of areas of commonality (Edwards 2002) and this is often seen as a result of the private sector corporate governance processes and structures being adopted in the public sector (Bowrey 2008). In the public sector there has been an ideological change which encompasses an increased focus on performance and responsibilities (Jackson and Lapsley, 2003) and the perceived need of the public sector to improve its efficiency, effectiveness and accountability (Guthrie 1998; Barton 2005).

One key component of an effective corporate governance structure is the implementation of internal audit function and the establishment of an independent audit committee. The following section outlines the role of internal audits and audit committees in Local Government Councils.

**Internal Audit**

Internal and external auditing is often considered to be similar however along with those similarities and synergies there are a number of key differences. The external auditing of councils is a statutory provision which requires the auditor to provide an opinion on the financial reports prepared as outlined in the Local Government Act (1993). The opinion issued by the external auditors is made available to the stakeholders of the council via the Annual Report. The audit work of the external auditor and the extent of the audit is mandated by the accounting and auditing regulations. Internal auditing differs from external auditing in that it is primarily used to provide independent assurance about the operations of the council whereas the external auditors provides financial assurance in relation to the council’s financial statements. The principle areas of concern for the internal audit functions include focus on how to monitor and improve internal controls, identifying areas of risk and evaluating methods of elimination, reduction or limitation of those risks so as to contribute to the governance of the Local Council (DLG 2008). The internal audit function assists Local government councils to meet the accountability needs of NSW State Parliament (Sendt 2002) as well as assisting them to achieve their objectives by providing an independent, objective assurance and consulting activity which is designed to add value and improve the council’s operations.

For management and councillors, an effective internal auditing function is able to provide a valuable resource due to the knowledge the internal auditors develop about the council, its culture, environment, operations and risk elements. Hence the internal audit function forms an important component of a council’s corporate governance framework (Subramaniam, Ng, & Carey, 2004). However while an integral part of the council the internal auditors need to maintain a level of separation and independence from management to reduce the likelihood of their role and activities being compromised. This is achieved by evaluating and finding ways to improve the effectiveness of managing risk, organisational controls and the governance aspects of the council (IIA 2011) with a level of professional objectivity. While the tasks, areas of investigation and activities of the internal auditor may be influenced by management, the intent is that they are able to also provide an independent perspective. Independence is achieved by the internal auditors reporting their findings directly to the audit committee, who then report to council, thereby maintaining a level of separation from management.

However for the internal audit function to be independent, both in fact and perception, there needs to be an effective and independent audit committee in the council. The internal audit committee performs a key role in supporting and overseeing internal audit activities by establishing the importance and direction of the internal audit process (DLG 2008), reviewing activities, understanding the organisations’ specific risks and approving resources when required. While the audit committee should not assume day to day oversight of the internal auditors the committee does need to have a good
understanding of the internal audit functions to satisfy themselves of the adequacy of the internal audit function and ensure that appropriate governance procedures are in place. The internal audit should be a major source of information for the committee about the organisation and open lines of communication between the committee and internal audit are essential to allow proper flow of information (ANAO 2011).

Members of the audit committee need to have the necessary skills, qualities and independence of mind to be able to function autonomously of management and act objectively in their deliberations. The strength of the audit committee should be the ability to demonstrate independence and the power to demand and seek information and explanations (ANAO 2011). The Auditing and Assurance standards board have issued a guide to good practice and although it is primarily focused on ASX (Australian Stock Exchange) listed companies it provides good guidance for public sector committees. One of the essential components highlighted for a committee to be effective is that the committee be free of undue influence with the committee members not having executive powers, management functions or delegated financial responsibility. A majority of independent members and an independent chair of the committee would demonstrate the ability to operate unencumbered by management and provide assurance the council are able to receive advice from an independent perspective (ANAO 2011).

This is reinforced by recommendations from the NSW Department of Local Government (DLG) that there be a strong, independent representation of members who are external to the council. The DLG suggested structure is that the chair be one of the independent members, that there should be 1 or 2 additional independent members and 1 or 2 councillors (DLG 2010b) and the council staff should only attend meetings in an observer capacity. While the DLG Internal Audit Guidelines of 2008 suggested that the Mayor or Deputy Mayor could be a member of the audit committee (although not the chair) this was later revised (DLG 2010a) to address the issues of independence with the recommendation that the Mayor not be a member of the audit committee (DLG 2010b).

For Local Councils an audit committee and an internal audit function are currently not requirements mandated by legislation, however a study by Sterck and Bouckaert (2006) concluded that when the audit function was mandated by regulation and where an audit committee was in place corporate governance was enhanced. At this stage the DLG Internal Audit Guidelines (2010b) state that good governance requires an audit committee, as it is pivotal to the governance framework, “and it is strongly recommend that all [emphasis added] councils have an internal audit function to provide good internal governance, ensure consistency, improve risk management, control and governance and instil public confidence” (p 7). Additionally the guidelines highlight the need for external audits to satisfy statutory requirements and for effective risk management which should be overseen by both the council and the audit committee (DLG 2010b). For Local Councils their ultimate aim should be to serve the public interest and provide services to the community (Laing 2007) on behalf of the government (Uhrig, 2003).

**Research Method and Data**

This research project is based on quantitative methodology where archival research was undertaken reviewing the 2009-2010 Annual Reports of the 152 NSW Local Government councils and their websites to determine the councils that had an audit committee. Of the 152 councils 101 (66%) provided no indication they had an audit committee while 48 (32%) councils indicated they did have an audit committee established. Of the three remaining councils one had a governance committee which covered audit, one developed an audit charter and one council’s website was inaccessible. The following chart presents this data.
The next stage of the review examined the structure and membership of each audit committee to evaluate the level of independence of the committee. Of the 48 committees it was found that the Mayor of the council was also a member of 21 (44%) councils’ audit committees. The following table presents this information.

Table 1: Regional and Metropolitan council Audit Committees and mayoral participation

<table>
<thead>
<tr>
<th>Council Type</th>
<th>Audit Committee</th>
<th>Audit Charter Only</th>
<th>No Audit Committee</th>
<th>No Web site access</th>
<th>Total</th>
<th>Mayor on committee</th>
</tr>
</thead>
<tbody>
<tr>
<td>Metropolitan</td>
<td>20</td>
<td>2</td>
<td>21</td>
<td></td>
<td>43</td>
<td>9</td>
</tr>
<tr>
<td>Regional</td>
<td>28</td>
<td>80</td>
<td>1</td>
<td></td>
<td>109</td>
<td>12</td>
</tr>
<tr>
<td>TOTAL</td>
<td>48</td>
<td>82</td>
<td>101</td>
<td>1</td>
<td>152</td>
<td>21</td>
</tr>
</tbody>
</table>

Discussion of Results

This preliminary research is based on information sourced from the councils’ websites, and their Annual Reports, and therefore there remains the possibility, though unlikely, that audit committees have been established in some councils but their existence has not been made public. If that is the case then the researchers believe that in the interests of both being independent and demonstrating independence that current disclosure practices are ineffective in providing information on the governance structure and processes. If these results are an accurate reflection of the current councils who function with and without audit committees it demonstrates that councils’ present compliance with DLG guidelines and the recommendations for good corporate governance are inadequate. Presently there is not a mandated requirement for councils to have an audit committee however it is strongly recommended the DLG include a “if not why not” condition which requires councils to explain why they are not following the guidelines.
With two thirds of Local Councils in NSW not having an audit committee it is clear that with DLG guidelines lacking the force of legislation that compliance with them is greatly diminished. Similarly even though the DLG has issued revised guidelines (DLG 2010b) to address issues of independence, one of which was that the Mayor not be a member of the audit committee, it can been seen that 21 (44%) of councils that have an audit committee also have the Mayor as a member and in some cases the Mayor is also the chair. In these circumstances it seems difficult if not impossible for the audit committee to serve its function of providing independent advice to management and the council.

Conclusion

This paper has explored the notion of corporate governance and how, and to what extent, Local Councils have implemented two key components of good corporate governance, an internal audit function and audit committee. While the results indicate a low level of councils actually having an audit committee there may be a number of legitimate reasons some councils have not established, at least in the short term, an audit committee. These could include lack of suitably qualified persons willing to work on an audit committee, particularly in regional areas, the cost of supporting the committee, a perceived lack of need for such a committee, or even a lack of understanding of the function of an audit committee. Similarly there may be reasons for including the Mayor on the committee, such as the skills which the Mayor may possess, the lack of skills of other councillors, the desire for control and oversight of the committee, or even that the Mayor was on the committee prior to becoming Mayor and has not resigned or been removed from the committee. However none of these justifications can continue to be used going forward as the critical importance of establishing and implementing the audit committee should be a dominant requirement of the councils.

This paper contributes to the literature on the corporate governance structures in Local Government Councils as well as on a practice level highlighting the current significant shortfall in the level of governance required and expected of Local Government Councils. Future research could extend on this initial study by undertaking a review of the 2012/13 Annual Reports to determine if there has been a change in the level of compliance in relation to audit committees. This extended study could be further enhanced through the collection and analysis of interviews with key stakeholders to identify the reasons some councils comply with the requirements of the Internal Audit Guidelines while others struggle or make conscience decision not to comply.

Reference List


NSW Trustees Act (1925), viewed 22 November 2013


