# Public Audit – Achieving Better Public Accountability

**Robert Buchanan***

> "In a number of different jurisdictions, Auditors-General have emerged as highly effective champions of public accountability, standing up for values such as transparency, probity and good governance …
>
> They have become central figures in the new, more pluralist version of public accountability, which seeks to supplement the traditional chain of ministerial accountability with alternative channels of accountability."
>
> Mulgan (2001)

The Public Audit Act 2001 came into force on 1 July 2001. It is a significant piece of legislation, because it:

- creates a new class of Officer of Parliament – for only the fourth time in New Zealand history; and
- strengthens the role of the Controller and Auditor-General[1] as an instrument of public accountability.

The courts have recognised the importance of "public accountability" legislation in New Zealand's largely unwritten constitutional arrangements. That legislation includes the Judicature Amendment Act 1972, the Ombudsmen Act 1975, the Official Information Act 1982, the Public Finance Act 1989, the New Zealand Bill of Rights Act 1990, and the Fiscal Responsibility Act 1994. The Public Audit Act is a new addition to the list.

The aim of this paper, therefore, is to explain what the Auditor-General does and show how the Act fits into the system of public sector accountability.

The paper is in three parts. The first is contextual. The second describes the Auditor-General's constitutional role and status, particularly the relationship with Parliament. The third part describes the system of public auditing which the Act implements.

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* Assistant Auditor-General – Legal, Office of the Auditor-General, Wellington. Views expressed are his own.

[1] The Act preserves the full title "Controller and Auditor-General", but uses the abbreviated term "Auditor-General". I also follow that approach in the rest of this paper.

# PART 1: CONTEXT AND ORIGINS

## 1.1 The growth of public sector auditing

The Auditor-General's role and profile in both central and local government have increased dramatically in recent years. Three things have contributed to this.

First, the nature of auditing has changed. Financial auditing has become concerned less with individual transactions than with an entity's underlying systems and processes of financial control. Public sector auditing has followed this trend – but has also expanded to include areas of scrutiny well beyond financial assurance. In New Zealand, this approach has become known as the "legislative" audit. Its elements include the audit of performance, waste, probity, accountability, and authority.

Secondly, the reforms in public sector management over the past 15 years in New Zealand have introduced new and more transparent accountability requirements on public sector agencies (Scott, 2001). Most notably, the move to an output focus in public expenditure, and the adoption of accrual accounting, have led to many new management practices. These in turn have increased the emphasis on the reporting of performance, and the use of external audit as a way of measuring performance (see *Reporting Performance*, OAG 2001).

Thirdly, expectations of public and political accountability have grown considerably. In New Zealand, as we shall see, the Auditor-General's work with Parliament and select committees has been especially important in securing the Executive's accountability to Parliament. But the Audit Office has also proved itself a reliable instrument for handling impartial inquiries into matters of political concern – both at central and local government level.

Two other changes have contributed to the growth of public auditing in New Zealand:

- the administrative separation (in 1992) of the Auditor-General's parliamentary, inquiry and performance auditing roles, which are managed by the Office of the Auditor-General ("OAG"), from the delivery of financial auditing and assurance services by Audit New Zealand and chartered accountants in private practice; and

- an evolving understanding of the underlying constitutional relationships between the Auditor-General, Parliament, and the public sector at large.

## 1.2 The origins of the Act

The Public Audit Act has its origins in two reports of Parliament's Finance and Expenditure Committee ("FEC").

## The 1989 Report on Officers of Parliament

In December 1988 the House of Representatives asked the FEC to investigate and report on:

- putting the Controller and Auditor-General on the same constitutional basis as the other Officers of Parliament;
- giving the House itself the power to decide on, and control, the funding of Officers of Parliament;
- ensuring the independent and effective discharge by Officers of Parliament of their duties; and
- defining, protecting, and enhancing the status and identity of the position of Officer of Parliament within the constitutional framework.

At the time, there was considerable debate over the role and status of the Auditor-General. An Opposition Private Member's Bill, in the name of Ruth Richardson MP, had sought to reinforce the Auditor-General's constitutional status by providing for Parliamentary – as opposed to Executive – appointment.

Of no less significance were concerns about the Executive Government's direct involvement in the funding of Officers of Parliament. These concerns were taken up in a joint submission to the FEC's inquiry, made by all of the existing Officers of Parliament[2] with the support of the Auditor-General.

The FEC's report on its inquiry (FEC, 1989) was the first, and so far the only, authoritative statement of the nature of an "Officer of Parliament" in the New Zealand constitutional framework. It described five criteria for the creation of an Officer of Parliament:

1. An Officer of Parliament must only be created to provide a check on the arbitrary use of power by the Executive.
2. An Officer of Parliament must only be discharging functions which the House of Representatives itself, if it so wished, might carry out.
3. Parliament should consider creating an Officer of Parliament only rarely.
4. Parliament should review from time to time the appropriateness of each Officer of Parliament's status as an Officer of Parliament.
5. Each Officer of Parliament should be created in separate legislation principally devoted to that Office.

[2] The Ombudsmen, the Parliamentary Commissioner for the Environment, and the Wanganui Computer Centre Privacy Commissioner (since abolished).

On the question of funding, the report recommended that each Officer of Parliament should be funded by a separate Vote, which would be subject to Parliamentary approval by the Estimates process. And in response to its first term of reference, the FEC had no difficulty in recommending that the Auditor-General should be recognised in statute as an Officer of Parliament, with a fixed term of office of 7 years.

In the event, it took more than 11 years for that recommendation to be implemented. However, the Auditor-General did receive an early benefit from the recommendation on funding. Parliament implemented this by:

- providing in the Public Finance Act 1989 for a separate category of organisation – the "Office of Parliament" – for funding and financial accountability purposes; and

- establishing the Officers of Parliament Select Committee to recommend estimates of appropriation for each Office and to carry out certain other oversight activities.[3]

The Public Finance Act included the Audit Office[4] in the definition of an "Office of Parliament". This was probably intended as a short term, transitional, move. But it meant that the Office came under the oversight of the Officers of Parliament Committee for funding purposes, from the Committee's inception.

**The 1998 Report on Audit Office Legislation**

For various reasons, the reform of the Auditor-General's enabling legislation made slow progress through the 1990s. There was ongoing debate throughout this period between the OAG and the Government – principally the Treasury and the State Services Commission – over the nature of the Auditor-General's role and mandate.

In 1997 the FEC launched a fresh inquiry into the policy issues involved in establishing a new legislative framework for the Audit Office. Its report (FEC, 1998) finally provided a platform for political consensus, on which the new Act has since been constructed.

The 1998 report endorsed the previous FEC's recommendations on the constitutional status and term of office of the Auditor-General. It also made recommendations on the scope and nature of the Audit Office's functions, its organisational arrangements, and its accountability. The report concluded by recommending new legislation governing the Audit Office "as a matter of priority".

**The passage of the Bill**

The Public Audit Bill was drafted before the 1999 General Election, adopted by the new Government following the Election, and introduced to the House in early 2000.

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[3] Standing Order 191 sets out the Committee's terms of reference.

[4] Including the Audit Department, which was a government department responsible for employing staff and providing administrative services for the Audit Office: see Public Finance Act 1977, s 15.

It received multi-party support, completed its third reading on 3 April 2001, and came into force on 1 July 2001.

The new Act was the first to receive Royal Assent by the new Governor-General, Dame Silvia Cartwright.

## 1.3 The purposes of the Act

The Public Audit Act implements both the 1989 and the 1998 FEC recommendations. Section 3 identifies two purposes:

- to make the Auditor-General an Officer of Parliament; and
- to reform and restate the law relating to the auditing of public sector organisations.

The first of these purposes reflects the Act's constitutional significance. The second reflects the growing emergence of the discipline of public sector auditing, and its importance as an instrument of public accountability.

Bridging the two purposes is section 9, which states simply:

> *The Auditor-General must act independently in the exercise and performance of the Auditor-General's functions, duties, and powers.*

The Auditor-General is, of course, the head of a professional auditing organisation as well as the holder of a significant public office. The duty of independence speaks equally to both capacities.

## 1.4 The public law context

The Act puts the Auditor-General in a strong position to satisfy accountability needs across the public sector. As public law, it provides a significant set of remedies. An Auditor-General's inquiry, in particular, is a new option among the various remedies available to those who are affected by, or concerned about, the improper or inappropriate use of public power or resources.

The range of options – besides recourse to the courts through judicial review – is already considerable. Each has its advantages in particular circumstances. For example, a commission of inquiry or a Ministerial inquiry is preferable to a select committee inquiry for finding facts and ascribing responsibility. One strength of a select committee inquiry, on the other hand, is to hold officials to account for a failure to implement policy. For an individual grievance, an investigation by an Ombudsman or another specialist complaint body may be preferable. Underlying all these remedies is the official information legislation.

As this paper will show, recourse to the Auditor-General also has its advantages in particular circumstances.

# PART 2: THE AUDITOR-GENERAL'S CONSTITUTIONAL ROLE AND STATUS

The Auditor-General has three traditional roles in New Zealand. They are:

- controlling and supervising the Executive's spending of public money – the ancient office of "Controller";[5]
- as the public auditor, helping Parliament to hold Ministers, officials and public entities responsible and accountable for their use of public money; and
- being the auditor of local government and a range of other public bodies.

## 2.1 The Auditor-General's independence from the Executive

As the 1989 FEC report observed, these "watchdog" functions fit neatly with the notion of an Officer of Parliament performing functions which the House itself, if it wished, might perform. Accordingly, the Act establishes the Auditor-General's independence from the Executive by making the Auditor-General an Officer of Parliament, who is:

- appointed by the Governor-General on the recommendation of the House, for a single term of up to 7 years with the same protection from removal as judges have;
- a corporation sole, with the power to appoint his or her own staff and determine the corporation's organisational form; and
- an "Office of Parliament" for the purposes of the Public Finance Act 1989.

The Act also:

- provides for a Deputy Auditor-General, also an Officer of Parliament, to be appointed for a renewable term of up to 5 years;
- abolishes the Audit Department; and
- provides for the House to appoint the auditor of the Auditor-General's financial statements.

(References: ss 7 to 13, 38; Schedule 3)

[5] The function itself is set out in section 22 of the Public Finance Act 1989.

## 2.2 Operational independence: contestable audit appointments

Sections 32 and 33 of the Act continue the Auditor-General's power to appoint auditors to undertake audits on his or her behalf. Since 1992, increasing numbers of appointments have been made contestable. If the public entity decides to go to the market, the OAG initiates a tendering procedure which is overseen by an independent evaluator. Private sector auditors then compete with Audit New Zealand, the Auditor-General's specialist auditing unit, for the appointment. The contestability system was introduced to address concerns about the efficiency of the public auditing system, and to improve the Audit Office's accountability for the use of its resources.

The Act does not, however, require contestability. This, and the Auditor-General's continuing ownership of Audit New Zealand with its specialist public sector auditing capability, are important to the Auditor-General's ongoing ability to operate independently – as section 9 requires. Compulsory tendering systems, and the loss of in-house capability, have been seen as significant threats to Auditor-General independence in Australia (Funnell, 2000, ch 7).

## 2.3 The Auditor-General's relationship with Parliament: balancing independence and accountability

An Officer of Parliament does Parliament's work, often at Parliament's bidding, and must be accountable to Parliament for so doing. But – and here is the paradox – an Officer must at the same time be independent from Parliament, both as to the choice of work and in its execution.

The Public Audit Act is the first Officer of Parliament legislation in New Zealand to describe this relationship in any detail. It does so using a carefully crafted balance between *independence* and *accountability*.

The principle of independence (section 9), and its importance, have already been mentioned. The principle is reinforced by the Auditor-General's:

- freedom to determine his or her own auditing approach (the term "audit" not being defined in the Act); and

- freedom from political direction as to work programme priorities.

Besides the accountability which goes with being an "Office of Parliament" under the Public Finance Act, there are two corresponding duties which provide the necessary checks and balances:

- a duty to publish, at three-yearly intervals by way of report to the House, the auditing standards which the Auditor-General applies, or intends to apply, in the conduct of audits and inquiries; and

- a duty to consult the House on each year's annual plan, and to identify any changes to work programme priorities requested by the Speaker or a select committee but not made.

The Auditor-General must also, in each year's annual report, give an account of the implementation of the preceding annual plan.

(References: ss 23, 36 to 38)

When it was introduced, the Public Audit Bill also contained a provision for the House to direct the Auditor-General on the work programme priorities, if it was dissatisfied with the outcome of the consultation process on the annual plan. But this provision was later rejected, on the ground that it would shift the balance between independence and accountability too far, and increase the risk of political interference.

**The relationship with select committees**

The constitutional relationship is not just an academic matter. It forms the backdrop to an extensive and increasingly important working relationship between the Auditor-General and Parliament. At its heart is the work which the OAG performs for parliamentary select committees.

In most other Westminster systems, Parliament's financial oversight role is given to a single select committee – usually known as the Public Accounts Committee ("PAC"). The equivalent committee in New Zealand is the FEC, to which the *Estimates* stand referred following the delivery of the Budget.[6] It is common for an Auditor-General to have a close involvement in the work of a PAC.

However, the FEC in New Zealand has power to refer a particular Vote to any subject select committee. That committee can then consider the Vote and report to the House. Indeed, that is what happens in practice. Subject committees also undertake financial reviews of departments and other entities, following the tabling of their annual reports and financial statements.

This type of devolution is not found in other jurisdictions similar to New Zealand. But it has a particular spin-off for the select committee system as a whole.

To help the subject committees perform their role of holding departments and other public entities to account, the Auditor-General assigns senior OAG staff (known as sector managers) as advisers to the committees on a permanent basis. The sector managers provide written and oral briefings on the *Estimates*, financial reviews and other reviews of performance. They also report on the results of annual and other audits. MPs often comment on the high quality of this advice and its benefits for the committees' financial scrutiny work.[7]

These interactions are regulated by a detailed protocol (Officers of Parliament Committee, 1994). There is no doubt that the protocol has improved the capacity of

[6] Standing Order 322.
[7] See, for example, the First and Second Reading speeches on the Public Audit Bill: (2000) 589 NZPD 1384 and 1401, (2001) 590 NZPD 8052.

select committees to perform in their various accountability roles. This at a time when the performance of Parliaments is coming under increasing scrutiny (Hazell, 2001).

But the benefits can extend even further. Some select committees use their OAG advisers as a source of advice on other matters – for example, the scrutiny of legislation or, more commonly, whether or how to conduct an inquiry into a particular matter. If an inquiry ensues, the adviser may be asked to assist. An example of this is the inquiry which the Primary Production Committee undertook in 1999 into the sale of the Property Division of the then State-Owned Enterprise, Terralink Ltd.

Alternatively, the committee may invite the OAG itself to undertake an inquiry and report to the committee – as happened, for example, with the inquiry into the purchase of the naval vessel *HMNZS Charles Upham* in 1998, and the inquiry into the purchase of computer equipment by Capital Coast Health Ltd in 1999.

The interrelationship between the two inquiry functions is explored further later on.

## 2.4 The Auditor-General's reporting role

The power to report is central to the Auditor-General's role and relationship with Parliament, the Executive, and local government. The Act has four specific reporting provisions:

- a duty to report to the House of Representatives at least once a year, besides the Auditor-General's own annual report (a power to report at any other time being implicit);

- a wide-ranging power to report to a Minister, select committee, public entity, or any person, in respect of "any matter arising out of the performance and exercise of the Auditor-General's functions, duties and powers that the Auditor-General considers it desirable to report on";

- a power to direct a local authority to table a report in a public meeting of the authority; and

- a special procedure enabling the Auditor-General to report on a loss incurred by a local authority – with a view to its recovery by the authority or, in default, the Crown.[8]

(References: ss 20 to 22, 50)

[8] This procedure replaced the power which the Auditor-General previously had to impose a financial surcharge on someone responsible for a loss or deficiency (Public Finance Act 1977, ss 30, 31). That power was seldom used, but its threatened use was occasionally valuable as a deterrent. The new procedure has a similar objective, but unlike the power of surcharge is available only in respect of local authorities.

**Reporting to Parliament**

Many of the Auditor-General's reports to Parliament contain recommendations for change. But their implementation is a matter for the Executive. Achieving implementation can be notoriously difficult, and is a source of frustration for Auditors-General everywhere. One disadvantage of an Auditor-General's inquiry in New Zealand, as opposed to that of a select committee itself, is that there is no requirement for the Executive to respond to a report within a particular time.[9]

This contrasts with the position in Canada, for example, where each report of the Auditor-General stands referred to the PAC after it has been tabled in the House of Commons. The Government must respond formally to each report within 150 days.

In New Zealand, the FEC has recently formed a subcommittee to consider each of the Auditor-General's reports to Parliament. It remains to be seen how this will work. And subject select committees sometimes also express interest, taking up issues from a report during their periodic examinations of public expenditure. An example of this is the aftermath to the Auditor-General's report on the New Zealand Tourism Board (1999).

**Reporting to local authorities**

The power to direct a local authority to table a report provides an alternative to reporting to Parliament on a matter which is primarily of interest to a local authority's electors. Had it been available, this power would probably have been used, for example, when the Auditor-General reported to Parliament on a review of the Auckland City Council's Britomart project in 1998.

## PART 3: THE SYSTEM OF PUBLIC AUDITING

The "reformed and restated" law on public auditing has three main elements. These elements concern:

- who the Auditor-General audits (portfolio);
- what the Auditor-General does (mandate); and
- how (powers and process).

I will address each element in turn. In summary, though, the Act achieves:

- a single, principled definition of the portfolio contained in a single statute – in contrast to the more than 80 public and local Acts which previously conferred jurisdiction;

[9] Compare Standing Order 248, which requires the Government to respond within 90 days to a select committee report.

- a single set of auditing and inquiry functions, which can be applied across the portfolio; and

- a set of powers which are both sufficient for operational purposes and appropriately circumscribed.

## 3.1 Who the Auditor-General audits: "public entity"

In the private sector, an entity appoints its own auditor. Under the Companies Act 1993, this is a task for shareholders at a company's annual meeting. The object is to have an auditor who will independently serve their, not the board's, interests.

The Auditor-General is the public sector's auditor. Defining the public sector for this purpose is a legislative function. But doing so in a principled way can be a challenge.

The courts use a test of "control" when determining whether an entity is an agent of the Crown for liability purposes (Hogg and Monaghan, 2000, ch 12). But doctrines of "public sector" accountability extend well beyond the Crown – for example, to local authorities, which are importantly *not* controlled by the Crown. And defining the public sector for some purposes – for example, Crown liability or tax liability[10] – is not necessarily suitable for others.

**The Hanan and Danks approaches**

The basis for the original Ombudsman philosophy in New Zealand was that an entity should be subject to jurisdiction if it was "perceived as being a government organisation by the public". This became known as the "Hanan principle", after the architect of the Ombudsman scheme.

Two decades later, the Danks Committee on Official Information used the basic test of whether an organisation "exercises government or public functions". The Legislation Advisory Committee's *Guidelines on Process and Content of Legislation* develop that test by describing a number of factors which can be relevant in determining the relationship between the organisation and central government.[11]

One of those factors, however, is whether an organisation is subject to controls on finance by the Auditor-General. This makes the test unsuitable for determining the Auditor-General's jurisdiction. Moreover, the Auditor-General's portfolio extends to local government as well as central government.

**The FEC's approach**

The 1998 FEC report described three principles which, it said, define when Parliament should appoint an independent auditor to represent the interests of taxpayers, ratepayers, or other stakeholders in a particular entity.

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[10] For example, see *CIR v Medical Council of NZ* [1997] 2 NZLR 297.
[11] See paragraph 9.5.2 of the 2001 edition.

The first principle was that Parliament should appoint the auditor of "all entities comprising the Crown's estate". The FEC stated this fundamental proposition:

> *As a matter of principle, we believe that Parliament should appoint the auditor of an organisation when it is to Parliament to which that organisation is ultimately accountable. Accountability is generally reflected in a requirement for an organisation's statements of account to be tabled in Parliament, and, in turn, for its performance to be subject to scrutiny by a select committee.*

In accounting terms, "the Crown's estate" means those entities which are consolidated into the Crown financial statements. But the principle is wider than this. If an entity is accountable to Parliament, Parliament should appoint its auditor. The FEC's approach is fundamentally sensible, because of the House's power to subject an entity's financial statements to scrutiny by way of a financial review.[12] The relevant select committee would expect the Auditor-General to be able to advise it should this happen.

Secondly, the FEC asserted Parliament's right to appoint the auditor of other "public sector" entities which are not primarily accountable to, or subject to scrutiny by, Parliament. It articulated the principle in this way:

> *As a general rule, Parliament should appoint the auditor of non-Crown public sector organisations where:*
>
> - *no practicable alternative exists for the community and other stakeholders of these entities to appoint an independent auditor; or*
>
> - *the entities exercise some form of coercive or significant power conferred by Parliament.*

The most obvious example of the first point is local authorities.

The third principle concerned subsidiaries and related entities. They should be treated in the same manner as their parent entities, "in order to protect the integrity of the accountability framework".

The report went on to say:

> *It does not necessarily follow that because Parliament appoints the auditor of an organisation, it should automatically appoint the Auditor-General to that role. It is the practice, however, that when Parliament appoints the auditor of an entity, it mostly does this by appointing the Auditor-General. There are three substantive reasons for this:*
>
> - *the Office of the Controller and Auditor-General has statutory independence.*

[12] Standing Orders 3(1), 329.

- *Benefits accrue from having a specialist professional agency principally devoted to serving Parliament's interests.*

- *Parliament obtains the administrative convenience and economy of having to appoint and deal with only one auditing agent.*

*We accept that, as a general rule, the Audit Office should be appointed as auditor of the organisations for which Parliament has asserted its right to appoint the auditor.*

**"Public entity": the term used in the Act**

The Public Audit Act translates the FEC's principles into the term "public entity", which is used to describe the Auditor-General's auditing portfolio. The term is defined in section 5(1) and (2):

> *(1) In this Act**, public entity** means each of the following entities:*
> *(a) the Crown:*
> *(b) each office of Parliament, except where another auditor has been appointed for that office under section 40(b) of the Public Finance Act 1989:*
> *(c) an entity of a class described in Schedule 1:*
> *(d) an entity listed in Schedule 2:*
> *(e) an entity in respect of which the Auditor-General is the auditor under any other enactment … :*
> *(f) an entity which is controlled by 1 or more entities of the kinds referred to in paragraphs (a) to (e).*
>
> *(2) For the purposes of subsection (1)(f), an entity is controlled by 1 or more other entities if—*
> *(a) the entity is a subsidiary of any of those other entities; or*
> *(b) the other entity or entities together control the entity within the meaning of any relevant approved financial reporting standard; or*
> *(c) the other entity or entities can together control directly or indirectly the composition of the board of the entity within the meaning of sections 7 and 8 of the Companies Act 1993 (which, for the purposes of this paragraph, are to be read with all necessary modifications).*

Section 5(1)(a) to (e) and the two Schedules encompass the entities covered by the first two principles. Section 5(1)(f) and (2) capture the third principle.

**Applying the second principle**

Existing legislation – including the Public Finance Act 1989 – made it comparatively easy to identify the entities covered by the first principle. However, there was considerable debate about the reach of the second principle, both during the FEC's 1998 inquiry and in the select committee stage of the Public Audit Bill. Community trusts (established under the Community Trusts Act 1999 – previously the Trustee Savings Bank Restructuring Act 1988) and energy trusts (which hold shares in energy companies) made two useful case studies.

In both cases, it seemed relevant to consider the nature of the trusts' functions, the origins of their assets, and who their beneficiaries were in relation to "the public". Community trusts exist for the purposes of their local communities, and their beneficiaries appear to be the public at large – although their funds originated from the trustee banks' depositors. Energy trusts also, arguably, perform functions on behalf of their communities. Their assets originated from the electric power boards which were abolished in the 1992 reforms.

When it considered the Public Audit Bill, the FEC at first decided that the community trusts should be included in Schedule 1, but later changed its mind (FEC, 2000). As for the energy trusts, these were thought not to meet the second principle in 1998 (FEC, 1998), but were eventually included in Schedule 1 following deliberation on the Bill. That inclusion was, however, short-lived, following the enactment of the Electricity Amendment Act 2001.[13]

In the end – as with the Hanan and Danks principles – the debate on these entities came down to a question of judgment, in this case as to whether each class of trust:

- exercises "public" functions; and
- is accountable to the public at large (or a section of the public) – whether as beneficiaries or in a wider sense,

to the extent that Parliament should intervene and appoint their auditor on the public's behalf.

**Applying the third principle: "controlled" entities**

The third of the FEC's principles is embodied in the test of "control" in section 5(2). Determining "control" is inherently difficult, but using an ownership approach to public sector definition enhances its certainty.[14]

The section uses three overlapping tests. The first, section 5(2)(a), draws on the legal definition of "subsidiary".

Secondly, section 5(2)(b) adopts the test of "control" used under generally accepted accounting practice ("GAAP"). From an accounting point of view, it is desirable that a single auditor audit the financial statements of each entity in a group. The use of financial reporting standards to define "control" will enable this.

At present, there is no "relevant approved financial reporting standard". However, a standard based on an exposure draft[15] is expected to be approved by the Accounting Standards Review Board in the near future. Once that happens, section 5(2)(b) has the advantage that any future changes to determining the "group reporting entity" in

[13] See section 22.

[14] A test based on ownership or control is generally easier to apply than one based on function, and is preferred by the courts for this reason (Hogg and Monaghan, 2000, 332). See also *CIR v Medical Council of NZ* [1997] 2 NZLR 297, 327.

[15] Institute of Chartered Accountants of New Zealand, *ED-84 Consolidating Investments in Subsidiaries* (2000).

financial reporting standards will automatically flow through to the Auditor-General's portfolio. If an entity is part of the group reporting entity of a public entity, the Auditor-General will be the auditor.

Thirdly, section 5(2)(c) defines control based on the Companies Act test of whether the parent entity can control the composition of an entity's governing body. This test was designed to pick up related entities which are trusts, which are not necessarily subject to consolidation under GAAP. The broader range of this test is important, because of the public expectation that trustees who are appointed by a public entity will be accountable to an independent auditor, irrespective of consolidation.

The "control" test is wider than GAAP in one other respect. Under GAAP, the question is whether a single entity has control of a related entity. However, an entity should logically be a public entity if two or more public entities together exercise control. Section 5(1)(f) and (2) address this point.

Section 5(2) significantly broadens the Auditor-General's portfolio. Previously, for example, the Auditor-General had no jurisdiction in respect of trusts or other ventures established by local authorities (unless they fell within the definition of a local authority trading enterprise ("LATE"), which is now a class listed in Schedule 1). Section 5(2) picks up all of these entities so long as one or more local authorities (or other public entities) can exercise control, as defined.

**Joint ventures and contracted out services**

Section 5(2) stops short of conferring jurisdiction in respect of:

- 50:50 joint ventures between public entities and other organisations; and
- services contracted out or devolved to the private sector.

In respect of joint ventures, there are sound public policy reasons for limiting the test to one of majority public entity control. However, the opposing argument is that public audit intervention may be justified where a joint venture entity is exercising similar public functions to those of the public entity partner, using public funds. This is especially likely to happen in the health sector.

Section 19 of the Act gives the Auditor-General a limited power to become involved in such cases, as the auditor of a non-public entity's financial reports. However, an appointment under section 19 can only be at the request of the entity concerned. It is also subject to a strict set of criteria (which are based on the second FEC principle). In other respects, a non-controlled joint venture is outside the reach of the Act.

There was considerable debate, when the Public Audit Bill was introduced, about whether the Auditor-General should have jurisdiction in respect of services contracted out to the private sector.[16] The debate was given focus by the controversy over a private provider of health and social services, the Waipareira Trust. The Trust had contracted with several government agencies to supply a range of services, but had

[16] See First Reading debate on the Public Audit Bill: (2000) 589 NZPD 1384 and 1401.

performed the services for less than the amount of public funds provided. It had then allegedly applied the surplus to other activities.

Some Australian Auditors-General have jurisdiction to examine the spending of grant money by community organisations. However, this approach is not favoured in New Zealand. The fact that an organisation spends public funds, either as a result of a grant by or on contract to a public entity, should not make it part of the public sector. Instead, the funding public entity should ensure that it makes the recipient of the funds accountable by contractual means. The public entity is, in turn, subject to the full range of public accountability legislation (including the Official Information Act and the Public Audit Act) for that enforcement activity.[17]

## 3.2 What the Auditor-General does: the public auditing mandate

Having defined the term "public entity" in a single provision, the Act then describes a single auditing mandate, which it makes available across the Auditor-General's portfolio. This contrasts with the previous position, where:

- the nature of the Auditor-General's financial auditing mandate appeared to differ as between those entities which were companies (in which case, the audit was conducted under the Companies Act) and those which were not; and

- the full public auditing mandate, including "effectiveness and efficiency" ("E & E") audits, applied to some entities – primarily, government departments, local authorities, and LATEs – but not others.

The mandate is set out in Part 3 of the Public Audit Act. There are four main functions.

**(a) "The auditor"**

Section 14(1) says that the Auditor-General is "the auditor" of every public entity. Deliberately, this term is undefined. Nor do any of the specific auditing functions which follow limit the generality of this provision (section 14(2)).

The generality of section 14 will enable the Auditor-General's role to develop in line with the evolving professional role of an auditor.

**(b) The financial report audit**

Section 15 says:

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[17] A more detailed analysis of this approach to public sector definition can be found in joint advice given to the FEC, in respect of the Public Audit Bill, by the OAG and the Treasury, entitled *The powers of the Auditor-General to audit public services provided by non-governmental organisations* – available on the OAG website www.oag.govt.nz/NewLegislation. The Treasury has since published *Guidelines for Contracting with Non-Government Organisations for Services Sought from the Crown*, intended for use by departments in their monitoring and enforcement of contracts. These are available on the Treasury website, www.treasury.govt.nz/publicsector/#documents.

> *The Auditor-General **must** from time to time audit the financial statements, accounts, and other information a public entity is required to have audited.* (emphasis added)

Again, the section stays clear of definitions. Nor does it try to be specific about what must be audited, or when. The section recognises that each public entity has its own accountability requirements, and that the nature of those requirements may vary according to its particular circumstances. What the section does is ensure that, to the extent that an entity's accountability documents must be audited, the Auditor-General has a duty to perform the audit.

Section 15 will, therefore, be able to keep pace with developments both in financial reporting and in public accountability generally. For example, introduction of a requirement for local authorities to produce audited "triple bottom line" accountability reports (including social and environmental, as well as financial, information) would not necessitate any amendment to section 15.

**(c) Performance audit**

Section 16(1) provides for a range of "performance audit" activities. The Auditor-General may examine:

> *(a) the extent to which a public entity is carrying out its activities effectively and efficiently:*
>
> *(b) a public entity's compliance with its statutory obligations:*
>
> *(c) any act or omission of a public entity, in order to determine whether waste has resulted or may have resulted or may result:*
>
> *(d) any act or omission showing or appearing to show a lack of probity or financial prudence by a public entity or 1 or more of its members, office holders, and employees.*

These functions describe several key components of the OAG's legislative audit model, which has provided a framework for its auditing standards since 1995. Paragraphs (b), (c) and (d) overlap with some of the procedures already required in a financial report audit.[18]

Performance audit is otherwise a discretionary activity which the Auditor-General can perform at any time, either in respect of a single entity or across a sector. Typically, a performance audit will combine various elements of section 16. Recent examples[19] include:

- a study of several government departments' client service performance (1999);

[18] For example, Auditing Standard AS-208 of the Institute of Chartered Accountants of New Zealand requires auditors to consider an entity's compliance with relevant laws and regulations.
[19] Most of the reports cited are available on the OAG's website (see note 17).

- a review of local authorities' governance of their subsidiary entities (2001);

- a study of how effectively the Crown is meeting its international environmental obligations within New Zealand (2001); and

- a review of the process used in the purchase of light armoured vehicles for the New Zealand Army (2001).

**The limits of "effectiveness and efficiency" audits**

E & E audits are subject to two statutory limitations under section 16:

- they are not exercisable in respect of the Reserve Bank or a registered bank; and

- an audit is limited to the extent to which activities are being carried on consistently with any applicable government or local authority policy.

The use of E & E audits in the commercial context can also be problematic. Parliament's conferral of this function in respect of SOEs has been criticised on the ground that it cuts across the governance model and commercial objectives of the State-Owned Enterprises Act 1986 (Chen, 2001).

It is certainly true that an E & E audit could involve the Auditor-General in forming an opinion on the appropriateness of a commercial judgment made by an SOE's board of directors. But this concern has to be placed in the context of what an audit is – and its primary emphasis on systems and processes, rather than reviewing specific transactions. It can be expected that the Auditor-General will tread carefully in this area and respect the rights of boards to make commercial decisions – much as the courts have done in limiting the availability of judicial review (*Mercury Energy Ltd v ECNZ Ltd* [1994] 2 NZLR 385).

In other respects, the argument for limiting the Auditor-General's role in respect of SOEs is similar to that periodically advanced in respect of whether the Official Information Act should apply to SOEs – ie, that the governance model under the State-Owned Enterprises Act provides sufficient accountability (Baumann, 1997). But the reality is that Parliament has always seen it as necessary to supplement the governance model with a range of other public accountability mechanisms (Law Commission, 1997, 15). The E & E function is little different from the others.

Indeed, the E & E function could be used to review the effectiveness of the governance model itself.

Parliament's reasons for conferring the E & E mandate in respect of SOEs appear to have been two-fold:

- There was a perception that the SOE model is concerned primarily with the accountability of SOE boards to their shareholding Ministers. Parliament's exact role in respect of SOEs is a matter for debate. But current practice (for example, select committees' regular use of the financial review procedure in respect of SOEs' annual reports) suggests the existence of a direct accountability interest to

Parliament as well as the indirect accountability which exists via the shareholding Ministers. The Auditor-General is Parliament's main adviser on accountability matters.

- The Public Audit Act should specify the Auditor-General's mandate consistently, and the function should be available, even if (as is likely) it is used sparingly.

**(d) Inquiries**

Finally, section 18 of the Act contains a broad function of inquiry into:

> *any matter concerning a public entity's use of its resources.*

An inquiry may take place on request or on the Auditor-General's own initiative. Its only constraints are those which also apply in respect of E & E audits (see above).

Although the function is a new one, in practice it recognises a longstanding expectation among the public, politicians, and local authorities that the Auditor-General will:

- look into matters of concern raised by members of the public about financial, accountability and governance issues in public entities; and

- undertake formal inquiries into, and report to Parliament on, matters of high public interest.

Until now, this work has been undertaken in the context of the Auditor-General's general function as the auditor of public entities, or as an audit of a specific transaction. It represents a substantial portion of the OAG's work, as shown in the table below.

*Inquiries received in the year ended 30 June 2001*

| | |
|---|---|
| • *taxpayers* | *60* |
| • *ratepayers* | *180* |
| • *Members of Parliament* | *60* |

(Source: OAG)

Many of these inquiries are conducted informally, at minimal cost, and are followed by a brief report back to the inquirer. However, others have addressed complex subject-matter and assumed a high public profile. On occasions, the outcome of an inquiry has had significant political consequences.

Section 18 has an undeniably broad scope. This creates both financial and political risks for the Auditor-General. The OAG uses considerable discretion in deciding what matters are taken up, and how they are addressed. Four points can be made about this.

First, many inquiries focus on issues of due process and good governance in respect of expenditure decisions. The references in section 16 to statutory compliance, probity, and financial prudence illustrate the Auditor-General's interest in this area.

Governance issues have been a feature of several inquiries concerning Crown entities. In the local government sector, inquiries commonly examine the statutory context of expenditure decisions. A recent example is the inquiry into a council's decision-making process in respect of a controversial sewerage scheme. The inquiry considered whether the financial management principles of the Local Government Act 1974 had imposed any formal procedural requirement to assess the costs and benefits of the scheme.

Secondly, it can be expected that the Auditor-General's inquiry function will continue to complement the power of inquiry by parliamentary select committees.

Parliament's growing interest in its inquiry role has been well documented and is unlikely to diminish in the near future. However, a select committee inquiry has limitations because of the inevitably political context and members' limited recourse to investigatory expertise. It has been suggested in the United Kingdom that select committee inquiry is not appropriate for achieving "investigatory" accountability (meaning fact-finding and allocating responsibility), as opposed to "remedial" accountability (Polidano, 2001). That may also be true in New Zealand, despite our select committees' greater powers of summons and access to information.

Like select committees, the Auditor-General has extensive powers to gather information and take evidence (including on oath). The particular benefit of recent major Auditor-General inquiries has been to find facts and "tell the story" behind politically charged, and often publicly distorted, events. Recent examples include:

- a report on allegations of Ministerial conflict of interest in the letting of a publicity contract (1997);
- an inquiry into the circumstances in which two members of the New Zealand Tourism Board resigned and received compensation payments (1999);
- an inquiry into the chartering of an aircraft by the Department of Work and Income to transport staff to a training seminar (1999);
- a review of the Airways Corporation's handling of conflict of interest allegations in respect of an overseas business venture (2000); and
- a review of two MPs' claims for a Parliamentary accommodation allowance (2001).

Thirdly, the Auditor-General is not a judicial officer. Each of the reports listed above avoided making definitive findings of fact based on the credibility of witnesses, or ascribing responsibility. If that is what is required, a judicial Commission of Inquiry is probably the better remedy.

Nevertheless, the remedy of an inquiry by the Auditor-General provides a significant and useful alternative to an inquiry by a select committee.

Finally, an Auditor-General's inquiry may not be a suitable remedy for pursuing an individual grievance. Often there will be other more suitable remedies – such as a complaint under the Ombudsmen Act, an investigation by one of the central agencies of government, or referral to the Police or the Serious Fraud Office. The Protected Disclosures Act 2000 also recognises the possibility of cross-referral in cases of employee disclosure.

These alternatives will have a useful rationing effect on the Auditor-General's use of section 18. Usually, the Auditor-General can be expected to become involved when an individual grievance discloses evidence of wider issues with a public entity's governance arrangements, management systems, or financial control environment.

## 3.3 How the Auditor-General works: powers and process

**Operational powers**

The operational powers of the Auditor-General are largely unchanged from the previous legislation, the Public Finance Act 1977. They include powers to:

- obtain documents, information, and explanations from any person;
- take evidence from any person, including on oath;
- if authorised by judicial warrant, inspect a bank account in a case where the Auditor-General has reason to believe that money belonging to a public entity has been fraudulently or wrongfully paid into the account; and
- enter a public entity's premises or (if authorised by judicial warrant) any other premises.

(References: ss 24 to 31)

These powers are more extensive than those in many other jurisdictions. For example, the Comptroller and Auditor-General in the United Kingdom has only limited power to obtain documents from some of the entities he audits (Sharman, 2001).

**Process**

The Public Audit Act is silent on matters of process. However, section 27 of the New Zealand Bill of Rights Act 1990 would apply to the Auditor-General's proceedings whenever a "determination" is made in respect of a person's rights, obligations or interests. Questions about section 27's scope aside, the rules of fairness and natural justice apply to the exercise of the Auditor-General's powers – including those to report – as in the exercise of any statutory power.

Not being a judicial officer, the Auditor-General does not hold hearings nor allow cross-examination of witnesses. But the standard audit practice of seeking comment and "clearance" on draft reports compensates for this, and generally ensures compliance with natural justice requirements.

## CONCLUSION

The Public Audit Act meets two broad objectives. The first is to clarify the Auditor-General's constitutional status as an Officer of Parliament. This has been long overdue. The second is to articulate the modern discipline of public sector auditing. Each of these objectives fuels the Act's potential to achieve better public sector accountability.

To some extent, the Act reflects what the Auditor-General has been doing for some years – for example, with select committees and in developing the concept of legislative auditing. Much of this work developed in response to changing public and political expectations. But the Act now provides a solid, principled platform for this evolution to continue. It will do so both in the parliamentary context – reflecting the Auditor-General's newly-confirmed status – and as a part of the broader framework of public law.

As with any office whose role is to inquire, report and recommend, the biggest measure of its success will be in its credibility with politicians and the public. The office currently enjoys a high level of credibility and trust. But that is only as good as the next report.

Choice of work, sound professional and political judgment, and quality of product will be the key ingredients in making the Act work.

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