

ACPAC Biennial 2007

“The Role of Auditors-General in relation to outsourced government activities/functions”

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Session 4 on Thursday 12 April 2007

Introduction

Good afternoon and thank you. I welcome the opportunity to address Parliamentarians working on, or with an interest in, Public Accounts Committees on a matter that has generated significant interest in recent years. The extent to which governments have outsourced certain functions, services or activities to the private sector, or in some cases to shared-services functions operating within the public sector, has varied in Australian jurisdictions.

When preparing this paper I was conscious of the need to acknowledge that decisions by governments to outsource public sector activities or functions are policy decisions made by them, which must not be questioned by Auditors-General. However, Auditors-General are well placed to assess the extent to which the implementation of policy decisions have been implemented effectively or efficiently.

Prior to considering the role of Auditors-General, this paper discusses what outsourcing means and the role played by public sector managers. I have also included a section considering the possible role that could be played by Public Accounts Committees.

This paper addresses the following:

- What is outsourcing?
- Why outsource at all?
- What functions/activities are commonly outsourced?
- The role of public sector managers.
- The impact of outsourcing on accountability
- Should Auditors-General have a role in relation to outsourced functions or activities?
- The role of Auditors-General – this will include a brief discussion about the mandates of Auditors-General in relation to outsourced functions/activities.
- Right of access and/or retention of records.
- An overview of the types of audit projects conducted by Auditors-General to date on outsourced activities/functions.
- The role, if any, of Public Accounts Committees.
- Conclusions.

This paper does not address outsourcing in the form of governments entering into Public Private Partnerships (commonly referred to as PPPs) or the purchase by Governments of services from Non-Government Organisations such as certain health services. However, in my view, the principles outlined in this paper generally apply to these arrangements.

What is outsourcing?

Outsourcing, which can also be referred to as contracting out, involves an external organisation taking responsibility for all or part a particular function or activity of a body (or agency)¹.

For example, a situation where an agency arranges for its Information Technology (IT) function to be provided for it by an external organisation, rather than having this function provided internally. The “external organisation” can be another public sector entity, such as in the case of shared service entities established within the public sector, or a private sector entity.

Why outsource at all?

Outsourcing is implemented for a number of reasons and, depending on the function or activity to be outsourced, these might include:

- savings in costs
- sharing or spreading risk
- access to more modern infrastructure such as current IT functionality and infrastructure
- improved support services
- maintaining standards
- better services to a customer or group of customers
- job creation and small business growth particularly in regional sectors²
- perceived lack of necessary skills within the public sector and or access to expertise and
- focussing public sector services on “core” services. In this regard it is noted that outsourcing is now common, and is growing, in the private sector. In this situation, private companies outsource activities such as recording routine accounting transactions to third parties enabling management to focus on what is regarded as ‘core’ business.

What functions/activities are commonly outsourced?

In my experience functions or activities outsourced have, in the main, related to corporate or “back office,” type activities rather than “core” services although some jurisdictions “purchase” some core services from the private sector. Examples include the purchase of health services from the Non-Government Organisation (NGO) sector.

Examples of corporate functions I have noted as outsourced include:

- IT functions

¹ As adapted from the ANAO’s Report No. 46 of May 2002 titled *Managing of an IT Outsourcing Contract* - page 6

² These six reasons were summarised from the ANAO report No. 46 *Managing of an IT Outsourcing Contract* – May 2002, page 12.

- cleaning services
- accounting services including payroll and financial reporting
- facility management
- human Resource services including OH&S, recruitment, training and development
- fleet management
- regulatory inspection services
- internal audit and
- warehousing and inventory management.

The role of public sector managers when functions or activities are outsourced

Clearly when an activity or function has been outsourced, the role played by the public sector manager changes from delivering a function to managing the delivery by a third party: a situation requiring uniquely different skills. Factors that public sector managers need to take into account when outsourcing include:

- Agencies themselves are ultimately responsible for the services they provide irrespective of whether these are delivered in-house or by outsourced providers: accountability and responsibility cannot be outsourced or abrogated.
- Agencies must operate within the relevant legislative and Government policy framework including any international obligations. This includes operating within a specific financial management and/or procurement policy framework as well as Treasurer's Instructions or equivalent.
- A common core principle underpinning Government procurement is Value for Money. This requires a comparative analysis of all relevant costs and benefits of each proposal throughout the whole procurement cycle.³

In addition, public sector managers must implement procedures ensuring that:

- Contracts entered into will facilitate:
 - Effective service delivery by the contractor;
 - Retention of accountability by the agency concerned;
 - A reasonable return for the contractor.
- The allocation of staff to the contract management process with appropriate contract management expertise.
- Effective monitoring and reporting processes to enable the agency to ensure that the service-level expectations are being satisfied.

This requires that public sector managers apply relevant project and risk management practices when planning an outsourcing arrangement. Matters for consideration by public sector managers when assessing risk and managing outsourced contracts include:

³ These three factors have been adapted from the ANAO's Better Practice Guide titled *Developing and Managing Contracts*

- Material potential benefits to the agency, the State and the community should be identified initially and continually throughout the project.
- Any impact of identified risks should be analysed and ranked in terms of importance.
- Reasonable and practical risk management and mitigation strategies should be developed and implemented.
- Adequate risk management and reporting mechanisms should be established.
- Ensure there is an appropriate allocation of risks to the parties best able to manage them taking into account value for money considerations.
- Ensure there are clear output and quality of service specifications. Normally this would detail the services required allowing the private sector service provider to decide how best to provide the services.
- Ensure the existence of performance based rewards. In this regard, payments should be contingent on performance standards being met.
- Where relevant contracts or service agreements include provisions aimed at achieving compliance with legislation.
- Finally, ensure that the agency has in place appropriate contingency arrangements and that plans are in place for contract conclusion including the possibility that the function/activity be in-sourced.

The impact of outsourcing on accountability

I pose the question - Does outsourcing change accountability? In this respect I noted from the NSW Audit Office's Contracting Out Review Guide a reference that in the Commonwealth, the Industry Commission has drawn attention to the need to preserve accountability when services are contracted out:

... while responsibility to do certain things can be transferred, accountability for the results cannot.

Whatever the method of service delivery, a government agency must remain accountable for the efficient performance of the functions delegated to it by Government ...⁴

I concur with the view expressed by the Industry Commission.

Should Auditors-General have a role in relation to outsourced functions or activities?

In response to this question I note that, if an accepted role of Auditors-General is assisting Parliaments in holding governments to account, then Auditors-General clearly have a role to play in auditing outsourced activities and functions. Further, consistent with my mandate, it is most appropriate, in fact it should be expected, that my Office has the capacity to audit outsourced functions or activities because, in most cases, such outsourcing will involve the expenditure of public monies. The audit of

⁴ Industry Commission Report No. 48, *Competitive Tendering and Contracting by Public Sector Agencies*, AGPS, Melbourne, 1996, pages 4-5 as extracted from New South Wales Audit Office – Better Practice – 1999 – Contracting Out Review Guide.

outsourced arrangements is also likely to give rise to considerations of the effectiveness, efficiency or economy of public sector activities or functions.

Any audit of outsourced activities or functions could involve assessments of matters such as:

- how effectively and efficiently these services were provided prior to outsourcing
- risks and benefits of entering into outsourcing arrangements
- expectations documented as part of the tendering specification
- service delivery standards proposed by the successful tenderer
- contractual arrangements, including the type of contract proposed, entered into and how the contract is to be managed by the public sector entity
- compliance with established tendering procedures
- performance reporting arrangements and their application in practice or
- expectations of what is to occur on contract completion including knowledge sharing and ownership of intellectual property.

As noted by the Industry Commission, the relevant public sector entity retains accountability for all of these processes.

The role of Auditors-General and their mandates in relation to outsourced functions/activities

Auditors-General in most Australian jurisdictions may conduct audits of efficiency and effectiveness. In this respect, these Auditors-General can audit outsourced arrangements where the audit objectives may include considerations of matters such as:

- The efficiency or effectiveness of the contract management arrangements.
- Whether or not the objectives specified when the decision to outsource was made are being achieved.

Where the entity to which a function or activity had been outsourced is also a public sector entity, such as a shared service department, Auditors-General can audit financial statements of such entities as well as conduct audits of the efficiency and effectiveness of the operations of such a department.

However, in most cases, such audits would consider these matters only from the perspective of the accountable entity – that is, the outsourcing agency. In some jurisdictions, Auditors-General can seek information from, and access to the records of, private sector contractors providing these services particularly where the agency is paying for these services. This is referred to in some circles as the Auditor-General being able to “follow the dollar”. This capacity exists at least in the Commonwealth, Victoria, Tasmania and Western Australia but has not, to my knowledge, been exercised in relation to outsourcing arrangements⁵.

⁵ The ANAO Audit Report No 42 of 1999-2000 *Magnetic Resonance Imaging Services—effectiveness and probity of the policy development processes and implementation* involved the use of s 32 power to obtain information

In two Australian jurisdictions (Queensland and the Northern Territory) the mandates are limited to audits of performance management systems although in Queensland this mandate was amended with effect from 1 January 2007 to enable the Auditor-General to review a public sector entity's performance measures. In this regard, and as it relates to outsourced functions or activities, audit work can be conducted to enable the Auditor-General to comment in a public report on whether or not the performance measures used by the agency to assess the performance of the contractor are relevant and/or appropriate.

In New Zealand, the Auditor-General has the mandate to examine efficiency, effectiveness, compliance with legal obligations and waste and probity in public entities (as defined in the Public Audit Act 2001). A large number of public (particularly social) services are delivered by non-governmental organisations (NGO's) in the not for profit sector mostly through contractual arrangements with public entities. The Auditor-General does not have jurisdiction over NGOs – although the Auditor-General does have powers under the Act to “follow” a public entity's money into another organisation when acting in the capacity as the auditor of the public entity. However, this power has rarely been used and can be difficult to enforce.

Right of access and/or retention of records

In my experience, where an agency outsources an accounting related function (for example, recording payroll) or an internal audit service, the outsourcing agency retains ownership of the relevant records. This enables the auditor to access and audit those records. However, it is important for contractual documentation developed as part of the outsourcing process to make this ownership clear and for access by audit to be specified.

Under the Commonwealth *Auditor-General Act 1997* the Australian National Audit Office (ANAO) has broad powers of access to records and information in the performance of its auditing responsibilities. This access extends to records and information held by third parties, but does not extend to access to third party premises⁶. Nevertheless, standard access clauses are inserted into contracts to allow both agencies and the Auditor-General access to information held by contractors⁷. It is expected that the need for ANAO access would be the exception rather than the rule, particularly if the agency has a robust control environment including sound

from persons outside the Commonwealth. The VAGO's performance audit *Grants to Non-government Organisations* in November 2000 “followed the money” to ensure it was applied for the right purpose.

⁶ *Auditor-General Act 1997 - Section 32 Power of Auditor-General to obtain information*

- (1) The Auditor-General may, by written notice, direct a person to do all or any of the following:
 - (a) to provide the Auditor-General with any information that the Auditor-General requires;
 - (b) to attend and give evidence before the Auditor-General or an authorised official;
 - (c) to produce to the Auditor-General any documents in the custody or under the control of the person.

⁷ These clauses can be found on the web site of the Commonwealth Department of Finance and Administration at http://www.finance.gov.au/procurement/standard_contract_clauses.html

monitoring and review of private sector involvement. The inclusion of a reference to access requirements in tender documents will ensure all parties are aware of the Commonwealth's position at the time of tendering.

An overview of the types of audit projects conducted by Auditors-General to date on outsourced activities/functions

My review of the web sites of recent performance audits conducted by Auditors-General in Australia noted completion of the following projects on matters relating to outsourced functions or activities (other than those undertaken as part of the financial audit process):

ANAO - Management of an IT Outsourcing Contract - Follow-up - Department of Veterans Affairs (DVA) in 2006. The objective of this follow-up audit was to assess the extent to which DVA had implemented the recommendations from the original audit during the period 2002-06, including in its preparation of the IT outsourcing contract which will operate from 2007.

ANAO - Legal Services Arrangements in the Australian Public Service - Across Agencies in 2004-05. The objectives of this performance audit were to: examine the efficiency and effectiveness of agencies' procurement and management of legal services arrangements; determine adherence to Australian Government policy requirements; examine the effectiveness of the Office of Legal Services Coordination's (OLSC) monitoring of agencies' compliance with government policy requirements; examine the OLSC's role in assisting agencies to comply with government policy.

ANAO - Australian Defence Force Recruiting Contract - Department of Defence in 2003-04. The objective of the audit was to examine Defence's management of the contractual arrangements for the provision of recruiting services to the ADF. The ANAO looked at the evaluations conducted at the end of each contractual phase, roles and responsibilities associated with ADF recruiting, and Defence's monitoring of contractual performance and management of risks associated with ADF recruiting.

ANAO - Monitoring of Industry Development Commitments under the IT Outsourcing Initiative - Department of Communications, Information Technology and the Arts (DCITA) in 2002-03. The objective of the performance audit was to review the progress in the delivery of contractual commitments for Industry Development (ID) for the five contracts awarded under the IT Outsourcing Initiative. In particular, the audit examined the effectiveness of the monitoring by DCITA of achievement against contractual commitments for ID; assessed the impact of changes to the IT outsourcing environment on the management and monitoring of ongoing ID obligations; and identified practices that have improved administrative arrangements.

OAG, WA - Contracting for Services - this audit reviewed four separate contracts in 1995. The audit aimed to gain a snapshot of current practice in contracting for public services in Western Australia, and identify scope for improvements. The audit found that all four contracts should result in net savings to Government, without apparent detriment to the quality of services provided.

VAGO, Victoria – Metropolitan Ambulance Service: Contractual and outsourcing practices – 1996-97. The audit was conducted following extensive outsourcing by the Metropolitan Ambulance Service in the period 1993 to 1995. A number of deficiencies in contract management were identified by the audit and it was concluded that savings estimated to be achieved from the outsourcing over a four year period had not eventuated.

VAGO, Victoria - Franchising Melbourne's train and tram system 2005 - The audit was conducted to determine whether the 2004 franchising agreements for the metropolitan train and tram system represented value for money. The audit in this instance did not follow the money trail.

NSWAO –Department of Commerce – Shared Corporate Services: Realising the Benefits - 2004. This audit used the first government provider of shared corporate services as a case study to illustrate the factors for success and issues requiring close management when consolidating human resources, finance, information technology and office services into one entity. The audit concluded that, under appropriate conditions, shared service arrangements are a proven method for obtaining significant cost savings from productivity improvements and economies of scale. However, the benefits realised in NSW from shared services were significantly below what was expected.

NSWAO – NSW Public Sector – Outsourcing information technology – across five agencies in 2002. The audit concluded that agencies managed the planning of outsourcing in a competent way and they satisfactorily managed the contractual aspects of outsourcing. However, there was no objective evidence to demonstrate that agencies achieved their goals in outsourcing IT.

It is evident from these audits that much work has been done by Auditors-General in relation to outsourced activities or functions and recommendations relevant to improving public sector performance were made in each case. This benefits their respective Parliaments and the agencies concerned.

The role, if any, of Public Accounts Committees

I focus my discussion in this section of my paper on the mandate provided to the Parliamentary Standing Committee of Public Accounts in Tasmania (the PAC) under the *Public Accounts Committee Act 1970* (the Act).

Under this Act, the PAC's functions include, and I quote from section 6 of the Act:

(1) The Committee must inquire into, consider and report to the Parliament on any matter referred to the Committee by either House relating to –

(a) the management, administration or use of public sector finances;

(2) The Committee may inquire into, consider and report to the Parliament on –

(a) any matter arising in connection with public sector finances that the Committee considers appropriate.

So, the PAC could inquire into the outsourcing arrangements where these give rise to any impact on public sector finances. I suspect that PACs in other jurisdictions have similar powers. In Tasmania outsourcing is uncommon and it may be unlikely that the PAC would exercise such powers in this instance.

In addition to the PAC role noted above, it is common for PAC's to follow up Reports issued by Auditors-General which would include audit of outsourced activities or functions.

In New Zealand, Parliamentary financial oversight of an NGO is possible if the entity is declared a "public organisation" under Standing Orders. Select committees' inquiry powers could however be exercised in relation to an NGO.

Conclusions

Some key messages from this paper include:

- While a government agency can outsource an activity to the private sector, and the private sector body provides the service to the taxpayers/ratepayers, they do so ultimately on behalf of the government agency. The government cannot outsource its duty of care.
- There must be an effective central framework in place by the government agency over the outsourced activity.
- Such frameworks should be a "win-win" but at the same time protect the "States-interest" in case of failure.
- Auditors-General need to provide assurance to the Parliament over the efficiency and effectiveness of service delivery and in doing so over the effectiveness of the control framework. This inturn facilitates PAC's follow up with the Executive with the aim of obtaining enhancements if required.
- Key aspects of such a control framework include:
 - contractual agreements which specify the rights and obligations of all parties which are conducive to the achievement of the government's desired outcomes
 - organisational arrangements which assign roles and responsibilities for managing agreements
 - monitoring procedures which utilise reliable information
 - procedures which address any deficiencies identified in the performance of service providers
 - payments to contractors in line with agreements and
 - outcomes in line with government expectations.

In concluding I reconfirm my view that Auditors-General have a role to play in ensuring that activities or functions outsourced to the private sector or to other public sector agencies are managed effectively and efficiently and that the outsourcing agency retains accountability for the activity or function outsourced. Thank you.

Mike Blake
2 March 2007

