

12 November 2006

File Ref: AM10-0210

Dear

REVISED ASSESSMENT FRAMEWORK WITHIN REPORTS TO MINISTERS AND SELECT COMMITTEES

I write to advise you of changes in our approach to reporting to Ministers and select committees, which will take effect from 2006/07. We expect the changes will improve the transparency, understandability, and usefulness of our reporting.

As you are aware, my Office reports to Ministers and select committees on the results of annual audits through letters to Ministers and briefings to select committees. Our reporting currently includes a section for our assessment of entities' financial and service performance "aspects", in the form of commentary and grades. Over the years, we have referred informally to this section as the "Five Management Aspects". Our new assessment framework will cover the same areas but in the simpler, easier-to-understand form of three "aspects":

1. Management control environment
2. Financial information systems and controls
3. Service performance information and associated systems and controls

Our short-hand term for referring to the new assessment framework will be "ESCO", to emphasise that the report is based on the environment, systems, and controls underlying the audited financial statements (including the statement of service performance (SSP)).

The most substantive change is to the basis upon which grades will be assigned; grades will now be based purely on any deficiencies observed by auditors and their corresponding recommendations for improvement. We expect that the reasons for the auditor's choice of grade will be clearer to you and other readers than under the current framework, and the commentary will focus attention on how things can be improved.

In addition, we will be placing a greater emphasis on our conclusions about the appropriateness of the service performance information in your SSP. To do this, we need to review your Statements of Intent (SOI) to determine the context for your SSP performance measures as well as your process and rationale for selecting them. Our shift in emphasis takes into account the recent changes in the Public Finance Act 1989 and the new Crown Entities Act 2004 reflecting the Managing for Outcomes/Results initiatives. Last year I reported to Parliament that the relationship between the outcomes a department seeks to achieve and the

outputs it delivers to contribute to those outcomes (Parts A and B of the SOI) has generally not been well enough developed, and considerable improvement is required. We expect that entities should now be bedding down the new requirements for SOIs and their outcome-to-output linkages. Service performance reporting, in particular the "appropriateness" of the service performance measures employed, is an area of audit emphasis in 2006/07 annual audits, and this emphasis will be reflected in the assessments we provide in our reports to Ministers and select committees.

We will begin reporting under the new assessment framework from the 2006/07 year. However, we will not assign grades for the service performance aspect in 2006/07, but we will provide comments on it. We want to undertake a concentrated review of 2007/08 SOIs next year and provide you with our feedback before we begin grading the service performance aspect for the 2007/08 year (taking into account your 2008/09 SOI).

A more in-depth explanation of our new approach to reporting to Ministers and select committees is attached. We will confirm and finalise the new assessment framework early in the New Year, so if you have any comments on it, we would appreciate receiving them by the end of January 2007. Please contact your Appointed Auditor if you would like to discuss any of the matters in this letter or its attachments.

Kevin Brady

Attachment 1 – ESCO: Revised Assessment Framework

Attachment 2 – Proposed draft Ministerial Letter reporting template

Attachment 1

ESCO: REVISED ASSESSMENT FRAMEWORK

BACKGROUND

Over the last couple of years, entities have expressed some concerns that the basis for their Five Management Aspects grades was not clear. They were uncertain whether auditor expectations were the same for all entities and about how any particular concern identified by the auditor might affect their grade for any specific aspect. This means they did not always understand why they received their grade and were not certain what management action might be required to improve it.

We have also been concerned that users'¹ perceptions of the Five Management Aspects assessment may differ from that intended. So in addition to improving the clarity and transparency of our assessment (so that users can better understand the basis for the entities' grades), we also wish to improve understanding about what the commentary and grades are based on, and what they do and do not provide information about.

Our reporting to Ministers and select committees includes our assessment of those areas of the management control environment, information systems, and controls necessary to support the production of the audited financial statements (incl. SSP). It is a by-product of the annual audit work and should not be seen as an overall assessment of management performance or of the entity's effectiveness in achieving its financial and service performance objectives.

The report is intended to provide information on the results of the annual audit to Ministers and select committees, and highlight areas needing improvement. This report also supports continual improvement by audited entities.

We have reviewed and refreshed the old Five Management Aspects framework to provide greater transparency about how grades are assigned. In addition, we have sought to ensure our revised "ESCO" framework aligns with our obligations under International Auditing Standards that are likely to come into effect in the next couple of years.

¹ Audited entities, Ministers, and select committees

WHAT THE NEW “ESCO” ASSESSMENT WILL LOOK LIKE

The changed framework affects only the section of the letter to the Minister (which is later incorporated in our reporting to the select committee) where assessments are provided; the remainder of that letter stays the same. The major features of the new framework are as follows:

We will report audit conclusions on three “aspects”.

1. Management control environment
2. Financial information systems and controls, and
3. Service performance information and associated systems and controls.

The report stems from the auditor's observations of the environment, systems, and controls that underlie and support the two main areas to which an audit opinion relates – the financial and service performance statements.²

Our commentary will emphasise areas for improvement

Under each of the three aspects, auditors will identify significant deficiencies observed during the course of the annual audit. For each deficiency identified, they will make recommendations for improvement. We expect that, in most instances, this commentary will cover selected areas from the Management Letter you will have already received, appropriately adapted for its audience (i.e. Ministers and select committees). The recommendations for improvement, individually and collectively, will determine which grade the auditor assigns for the aspect.

In addition to focusing on areas for improvement, auditors will use their discretion to provide brief general comments to place their discussion of deficiencies in a proper context.

We will use a four-point grading scale

The current, “Five Management Aspects” framework has a five-point scale.³ We have reduced the points on the scale by one for ESCO, with our deficiency-and-recommendations-based scale offering a simpler and clearer explanation of why entities have been given the grades they have:

1. **Very good** - no improvements necessary.
2. **Good** - improvements would be beneficial and the entity should address them during the forthcoming year.
3. **Needs improvement** - improvements are necessary and should be addressed at the earliest reasonable opportunity.
4. **Poor** - major improvements are required, to which the entity should give urgent attention.

² The current “five management aspects” are (1) Financial Control Systems, (2) Financial Management Information Systems, (3) Financial Management Control Environment, (4) Service Performance Information and Information Systems, and (5) Service Performance Management Control Environment.

³ (1) Excellent, (2), Good, (3) Satisfactory, (4) Just Adequate, and (5) Not Adequate.

We will provide better explanatory notes

To enhance users' understanding of what is covered in the ESCO assessment and how the grades are derived, we will provide information explaining the subject matter relating to each aspect as well as the assumptions underlying the auditors' assessments.

The most important point is that the auditor's conclusions on deficiencies (i.e. the gap between "how things are" and "how they should be"), and the associated recommendations for improvement, are based on the auditor's assessment of how far short things are from "best practice". The auditor's notion of "best practice" is based on their professional expertise and judgement, taking into account what is deemed appropriate for each entity, given its size, nature and complexity.

Another important assumption relates to the cost-benefit of introducing improvements; auditors will recommend improvements only when they consider (in their professional judgement) that the benefit of the improvement will justify its cost. We realise that you will consider cost-benefit decisions are your prerogative, and we agree. However, it is the Auditor-General's role as the public sector's auditor to consider effectiveness and efficiency in the context of our audit work, and this will be built into any recommendations for improvements.

Our explanatory information will also explain why grades may fluctuate from year to year; this could happen even if nothing has changed within your entity. Some of the factors that may cause the "goalposts to move" include changes in the operating environment, standards, best practice expectations, or auditor emphasis. In using the ESCO assessment, it is therefore important to keep in mind that:

- How you respond to the auditor's recommendations for improvement, as they arise, is more important than the grade change from year to year (i.e. because the goalposts may move from year to year, e.g. a downward shift in grade may not indicate deterioration – it may just be that things have not kept pace with good practice expectations for like entities).
- Consequently, the long-term trend in grade movement is a more useful indication of progress than year-to-year grade changes.

Benefits

There are two major benefits in moving to a deficiency-and-recommendations-based grading system:

1. The basis of the grading will be more transparent because the identified deficiencies and recommendations that drive the grade will be reported as clearly and concisely as possible in both the Management Letters to entities and our reporting to Ministers and select committees
2. The ESCO assessment will focus on opportunities for improving the environment, systems, and controls. This should encourage entities and auditors to constructively debate the risks posed by the deficiencies and the options to address these, rather than simply debating the grade itself.

GREATER EMPHASIS ON SERVICE PERFORMANCE INFORMATION

Service performance information in SOIs and annual reports, in particular the “appropriateness” of the service performance measures employed, is an area of audit emphasis in 2006/07 annual audits. This emphasis will be reflected in the assessments we provide in our reports to Ministers and select committees.⁴

Our view is that the work to establish outcome reporting and associated outcome-related measures, as required by recent legislative changes, should now be sufficiently well developed and linked logically to output reporting. Accordingly, our auditors will reflect the greater emphasis on service performance information in our reporting to Ministers and select committees. This includes the audit conclusions on the appropriateness of forecast output measures and targets, in the context of an entities’ reported outcomes, along with the process and rationale for selecting them. This, in turn, includes consideration of:

- The determination and review of service performance information needs and the choices about what to report (i.e. the quality of the SOI in relation to the entity’s vision, mission, and strategic intent etc; the choice of elements (outputs and activities));
- The choice of properties, characteristics, or dimensions of the elements (performance measures);
- The chosen levels of planned performance (the standards or targets aimed for).

Our expectations in respect of these matters are aligned with the guidance and instructions issued by the State Services Commission and the Treasury⁵.

Shortcomings identified in our reviews of service performance reporting will, in future, impact on gradings more significantly than they have to date, for two reasons: (1) our move to a deficiency-and-recommendations-based grading system, and (2) our auditors giving greater emphasis in their reports to the appropriateness of performance measures. To allow you time to adjust to this change of emphasis, we will not issue grades for the service performance aspect in the 2006/07 ESCO assessment.⁶ Instead, we will provide you with feedback after reviewing your 2007/08 SOI, and our ESCO assessment in 2006/07 will include some commentary on the direction your auditor believes any improvement should take. We will grade the service performance aspect for the first time in the 2007/08 ESCO assessment.⁷

We expect to review many entities’ 2007/08 SOIs at the draft stage. Your Appointed Auditor can advise you of whether we expect to be able to review your draft SOI and offer our feedback before the SOI is finalised. If we do expect to review your draft SOI, we ask that you advise your Appointed Auditor of your SOI preparation timetable.

⁴ Refer to our Parliamentary Paper, *Central government: Results of the 2004-05 audits*, B.29[06a], Part 7, pp69-75.

⁵ Refer to *Guidance and Requirements for Departments: Preparing the Statement of Intent*, State Services Commission and the Treasury, December 2005 and *Preparing the 2006/07 Statement of Intent – guidance and requirements for Crown entities*, State Services Commission and the Treasury, September 2005.

⁶ This will relate to the 2007/08 SOI and the 2006/07 SSP.

⁷ Which will cover the 2008/09 SOI and the 2007/08 SSP.

Attachment 2

GRE-1

Date 200X

Our Ref:

[Minister's name]
[Minister's portfolio]
Parliament Buildings
WELLINGTON

Dear Minister

[ENTITY]: AUDIT FOR THE YEAR ENDED 200X

1 INTRODUCTION

1.1 We have completed the audit of the [entity] for the year ended 200X. This letter provides a summary of:

- the audit opinion;
- our conclusions on the [entity's] environment, systems, and controls for measuring financial and service performance;
- our assessment of the [entity's] compliance with legislative requirements; and
- the matters of significant audit interest.

1.2 All matters mentioned have already been drawn to the attention of the Board and the Chief Executive [where applicable].

2 AUDIT OPINION

2.1 We issued an [un]qualified/adverse audit opinion on the [entity's] financial statements.

3 ENVIRONMENT, SYSTEMS, AND CONTROLS FOR MEASURING FINANCIAL AND SERVICE PERFORMANCE

3.1 The auditor's conclusions on the [entity's] management control environment, systems, and controls for measuring financial and service performance, for the year ended DD MMM 200X, are set out in the table below.

3.2 The conclusions are made in the context of the auditor's work in forming an opinion on the financial and service performance statements. The purpose of commenting on the underlying environment, systems and controls is to highlight areas for improvement identified during the audit, and the grades assigned directly represent the recommendations for improvement as at DD MMM 200X. This is not an assessment of overall management performance or of the entity's effectiveness in achieving its financial and service performance objectives. (See the Appendix for an explanation of the grading scale and underlying assumptions.)

Management Control Environment	
<< Grade >> (200X ⁻¹ <Grade>)	<< Corresponding 'explanation of grade' for 200X >>
Comment	
<ul style="list-style-type: none"> • [Deficiency and recommendation for improvement #1]. • [Deficiency and recommendation for improvement #2]. • [Deficiency and recommendation for improvement #3]. etc <p>Comments on specific recommended improvements in the context of the overall aspect (i.e. comments on the general state of the MCE).</p>	
Financial information Systems and Controls	
<<Grade>> (200X ⁻¹ <Grade>)	<< Corresponding 'explanation of grade' for 200X >>
Comment	
<ul style="list-style-type: none"> • [Deficiency and recommendation for improvement #1]. • [Deficiency and recommendation for improvement #2]. • [Deficiency and recommendation for improvement #3]. etc <p>Comments on specific recommended improvements in the context of the overall aspect (i.e. comments on the general state of the systems or controls).</p>	
Service Performance Information and Associated Systems and Controls	
<<Grade>> (200X ⁻¹ <Grade>)	<< Corresponding 'explanation of grade' for 200X >>
Comment	
<ul style="list-style-type: none"> • [Deficiency and recommendation for improvement #1]. • [Deficiency and recommendation for improvement #2]. • [Deficiency and recommendation for improvement #3]. etc <p>Comments on specific recommended improvements in the context of the overall aspect (i.e. comments on the general state of the systems or controls).</p>	

4 LEGISLATIVE COMPLIANCE

4.1 We reviewed the systems and procedures employed by the [entity] to identify and comply with legislative requirements. [No issues arose that need to be drawn to your attention/ The following issues are drawn to your attention.....]

5 MATTERS OF SIGNIFICANT AUDIT INTEREST

5.1 The following matters of significant audit interest were considered in the audit. [Either discuss issues considered, or say "No matters of significant audit interest arose that need to be drawn to your attention".]

I would be pleased to meet with you should you require further information about the matters mentioned in this letter or, more generally, about the audit of the [entity].

Yours sincerely

[name of relevant Sector Manager]
Sector Manager

APPENDIX

Further explanation of scope and grades

	Indicative Areas
Management Control Environment	<p>This is the foundation of the control environment and may include consideration of the following:</p> <ul style="list-style-type: none"> • Clarity of strategic planning • Communication and enforcement of integrity and ethical values • Commitment to competence • Participation by those charged with governance, e.g. the involvement and influence of Audit Committee and Board (or equivalent) • Management philosophy and operating style • Organisational structure • Assignment of authority and responsibility • Human resources policies and practices • Risk assessment and risk management • Key entity-level control policies and procedures • Information systems and communication (incl. information technology planning and decision making) • Monitoring • Legislative compliance arrangements
Financial Information Systems and Controls	<p>These are the systems and controls (incl. application level computer controls) over financial performance and financial reporting and include the following:</p> <ul style="list-style-type: none"> • Appropriateness (and timeliness) of information provided • Presentation of financial information • Reliability of systems • Control activity (incl. process-level policies and procedures) • Monitoring • Legislative compliance
Service Performance Information and Associated Systems and Controls	<p>This concerns the quality of the service performance measures selected for reporting against, as well as the systems and controls (incl. application level computer controls) over service performance reporting, and includes the following:</p> <ul style="list-style-type: none"> • Appropriateness (and timeliness) of information provided and reported • Presentation of SSP information • Reliability of systems • Control activity (incl. process-level policies and procedures) • Monitoring • Legislative compliance

Grade	Explanation of grade
Very good	We recommend that no improvements are necessary.
Good	We recommend that improvements would be beneficial and the entity addresses them during the forthcoming year.
Needs improvement	We recommend that improvements are necessary and should be addressed at the earliest reasonable opportunity .
Poor	We recommend that major improvements are required , to which the entity should give urgent attention .

Notes on Environment, Systems, and Controls for Measuring Financial and Service Performance

1. The reporting under Part 3 of this Letter, *Environment, Systems, and Controls for Measuring Financial and Service Performance*, is a by-product of the underlying audit work carried out to form an opinion on the financial and service performance statements. Its scope is limited to those areas of the management control environment, information systems, and controls the auditor has given attention to during the course of the audit.
2. Recommendations for improvement are generally limited to those findings that the auditor considers are material weaknesses in the design or operation of the management control environment, information systems, or controls. The recommended improvements determine the grade assigned. A single, serious deficiency drawing a recommendation for improvement may, of itself, determine the grade. Similarly, the most serious deficiency among several will draw a stronger recommendation and affect the grade accordingly.
3. Deficiencies in the management control environment, information systems or controls are the gaps between what auditors observe and what auditors determine, in their professional judgement, constitutes best practice (see below). Auditors' professional judgement is informed by many factors, including national and international standards, knowledge of best practice, and standards and expectations for the public sector in New Zealand.
4. To help ensure the relevance to all entities of the auditor's recommendations and grading, the auditor's recommendations are made with reference to what is considered best practice given the size, nature, and complexity of the entity. Thus notions of best practice will vary among entities because what is considered necessary, sufficient, or beneficial for some entities may not be so for others. There is therefore not a "one size fits all" standard across the public sector. Rather, recommendations for improvement are based on the auditor's assessment of how far short the entity is from a standard that is appropriate for the entity's size, nature, and complexity of its business.
5. Further, notions of best practice may vary across time in response to change, for example, changes in the operating environment, changes to standards, and changes in general expectations. Grades assigned to entities may therefore fluctuate from year to year according to how entities respond to changes in the environment and in best practice expectations. Grades may also be affected from year to year because of changes in emphases, in accordance with the auditor's risk-based approach to testing systems and controls.
6. Improvements are recommended only when it is considered, in the auditor's judgement, that the benefits of the improvements would justify the costs.
7. Recommendations for improvement are based on the auditor's conclusions about the state of the entity's management control environment, information systems, and controls as at the financial year end.