

VICTORIA

Auditor-General
of Victoria

CONTROL AND COMPLIANCE AUDITS

Payroll management

and

**Administration of the
goods and services tax**

March 2003

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Parliament House
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I am pleased to forward this report to you for presentation to each House of Parliament, pursuant to section 15 of the *Audit Act* 1994.

This report sets out the results of control and compliance audits undertaken of *Payroll management* and *Administration of the goods and services tax* by Victorian government departments and other public sector agencies.

Yours faithfully

J.W. CAMERON
Auditor-General
27 March 2003

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Foreword

Key responsibilities of all public sector agencies include ensuring compliance with legislation, and maintaining appropriate governance and financial management processes.

I have decided to expand my Office's focus on reviewing the performance of agencies in discharging these responsibilities through the conduct of targeted control and compliance audits. These audits will be aimed at providing assurance to Parliament on the effectiveness of key management activities and at enhancing the quality of management processes within agencies.

This report outlines findings associated with the first of these audits, namely Payroll management and Administration of the goods and services tax in government departments and a selection of other agencies.

Overall, we found that both payroll and the goods and services tax were effectively managed by agencies. However, we identified opportunities for many agencies to further enhance management of these functions through the implementation of additional control mechanisms.

We also identified a range of better practices used by certain agencies for the management of payroll and the goods and services tax. Adoption of similar practices in all agencies may be beneficial in improving the quality of financial management throughout the Victorian public sector.

Yours faithfully



J.W. CAMERON
Auditor-General

27 March 2003

Part 1

Executive summary

INTRODUCTION

1.1 Government departments and other agencies are responsible for the financial management and control of significant expenditure of State funds and for ensuring compliance with various financial requirements under Commonwealth and State legislation.

1.2 Two areas of significance in relation to these responsibilities are payroll management, and the administration of the goods and services tax, following the introduction of this tax by the Commonwealth Government from 1 July 2000.

PAYROLL MANAGEMENT

Audit objectives and scope

1.3 Payroll and other employee-related expenditure is the major component of the total financial resources consumed in many public sector agencies. The financial position of an organisation can be dependent on the extent to which payroll expenditure is effectively planned, processed and managed. Accordingly, a targeted audit of ongoing management of the payroll function was undertaken.

1.4 The key objectives of the audit were to:

- establish whether effective systems of internal control had been implemented for the payroll function within agencies;
- determine the extent to which controls had been complied with as part of the ongoing management and monitoring of payroll expenditure;
- assess whether the payment of salaries and related expenditure was made in accordance with relevant terms and conditions of employment; and
- identify better practices that could be applied by other agencies to improve the effectiveness of their payroll management.

1.5 The audit was undertaken in all government departments, the Parliament of Victoria and a number of other public sector agencies.

Audit conclusion

1.6 Overall, agencies subject to audit examination had sound policies and practices in place to control the payroll function. We identified, however, that opportunities existed in many agencies to further strengthen payroll management through the implementation of additional procedures in areas such as:

- regular analysis of the costs and benefits of existing payroll management arrangements compared with potential alternatives, such as outsourcing and consideration of benchmarking the efficiency of the payroll process to similar agencies;
- adoption of a systematic approach to the assessment of payroll processing risks as part of overall risk management strategies within agencies;

- development of additional policy and procedural guidance for payroll activities;
- implementation of additional control processes to minimise the risk of errors or exceptions in payroll transactions; and
- placing greater emphasis on independent monitoring and review processes, including the use of internal audit, to provide assurance to agency management over the accuracy and completeness of payroll processing.

Recommendations

<i>Paragraph number</i>	<i>Recommendation</i>
Public sector environment for payroll management	
2.26	<p>Agencies operating in a decentralised environment should ensure that sufficient training and guidance is provided to all staff involved in the payroll process to resolve risks associated with inconsistent practices emerging between various agency locations and to minimise the incidence of errors arising from delays in processing changes in payroll data.</p> <p>All agencies should implement a policy for periodic review of the costs and benefits of existing payroll administrative processes compared with potential alternatives.</p> <p>Consideration should be given by agencies to greater use of on-line facilities for dissemination of payroll information.</p>
Managing payroll risks	
2.38	<p>All agencies should:</p> <ul style="list-style-type: none"> • adopt a formal and systematic approach to risk assessment in respect of the payroll function; • consider the specific risks that may arise from the management of payroll; and • ensure that responsibility for ongoing payroll risk management is clearly allocated to relevant management of the agency.
Control environment for payroll	
2.46	<p>Agencies should consider:</p> <ul style="list-style-type: none"> • implementation of a systematic approach for the regular review and update of payroll policies and procedures; • development of additional policy and procedural documentation to ensure that all key areas of the payroll process are addressed; and • introduction of specific policy guidance to support the use of email for approval of changes to payroll data.

Recommendations - continued

Paragraph Number	Recommendation
Payroll controls and processes	
2.55	<p>All agencies should:</p> <ul style="list-style-type: none"> • undertake periodic reviews of control processes to ensure that they remain appropriate in ensuring the validity and accuracy of payroll transactions; • strengthen controls in areas such as checking versions of payroll files, reconciliation of payroll totals to other financial records and the security of payroll information; • consider greater use of exception reporting as a key method of oversight for changes to payroll data, exceptional or unusual transactions and the reasonableness of amounts processed and recorded; • implement additional control procedures and consider additional staff training to minimise errors or exceptions identified in payroll processing; and • pay particular attention to existing controls or the implementation of more stringent processes to address the additional risk of error that arises at times of substantial change to payroll data, such as the processing of general award rises for large numbers of employees.
Monitoring and review of payroll	
2.68	<p>All agencies should ensure that, at a minimum, key payroll functions are subject to internal audit review on a cyclical basis.</p> <p>Agencies should adopt a more systematic and formal approach to other monitoring and review activities, which would provide management with ongoing assurance over the accuracy and completeness of payroll processing and the efficiency of payroll administration.</p> <p>Consideration should be given by agencies to the implementation of benchmarks for the payroll function using comparative information of their performance against benchmarks achieved by comparable agencies.</p>

ADMINISTRATION OF THE GOODS AND SERVICES TAX

Audit objectives and scope

1.7 The Commonwealth's *A New Tax System (Goods and Services) Act 1999* introduced major changes to the Australian tax system, including implementation of a goods and services tax (GST) from 1 July 2000. As State Governments are required to comply with GST legislative requirements, significant responsibilities have been placed on both government and other public sector agencies, many of which had limited prior exposure to the management of indirect taxation requirements. We have recently reviewed the effectiveness of agencies in managing these taxation responsibilities.

1.8 The objectives of our audit were to:

- assess the effectiveness of the State's taxation compliance assurance framework as a tool for managing the State's risks in complying with GST requirements;
- ascertain the extent to which individual public sector agencies are complying with the State directions and rules established under the State's tax compliance assurance framework for the GST;
- review the effectiveness of policies and processes within individual public sector agencies to implement, control and manage GST requirements; and
- review the level of compliance by individual agencies with Commonwealth legislative and Australian Taxation Office requirements relevant to the GST.

1.9 The audit was undertaken in government departments, the Parliament of Victoria and the Office of the Chief Commissioner of Police.

Audit conclusion

1.10 Substantial effort was devoted by the Department of Treasury and Finance and other agencies during the implementation phase of the GST regime to managing a range of issues such as the upgrading of financial systems, training of staff and resolution of GST issues specific to government agencies. As a result of these activities, all agencies examined had in place a range of controls to manage compliance with GST requirements and to ensure the accuracy of data processing related to the GST.

1.11 Notwithstanding the existence of effective controls, scope remains to improve the ongoing administration and control of the GST within agencies. An examination of transactions and processes within each agency identified continuing errors in the processing of GST transactions resulting mainly from:

- the availability of valid or complete tax invoice documentation to support the claiming of input tax credits;
- the accuracy of calculations of the GST paid on certain invoices received from suppliers;

- the incorrect coding of GST transactions; and
- lack of detail to support the GST treatment of certain transactions specific to the public sector.

1.12 In relation to this latter point, a need exists for clarification, with the Australian Taxation Office, of the correct classification of certain payments made by departments as either government appropriations, which are exempt from the GST, or grants, on which the GST is required to be paid.

1.13 We also identified a range of better practices used by agencies for the administration of the GST. Ensuring that similar practices are implemented across all agencies may be beneficial in improving the quality of GST administration throughout the Victorian public sector.

1.14 A major initiative of the Department of Treasury and Finance has been the development and implementation of a tax compliance framework for the Victorian public sector. This framework is aimed at setting standards for compliance by all public sector agencies with Commonwealth tax requirements. Successful implementation of this framework by agencies will provide an effective mechanism for ensuring ongoing compliance with GST requirements.

Recommendations

<i>Paragraph number</i>	<i>Recommendation</i>
Effectiveness of GST controls and processes	
3.43	Implementation throughout the Victorian public sector of better practices identified in certain agencies may be beneficial in improving the quality of GST administration.
Need for clarification of treatment of financial supply transactions	
3.48	The Department of Treasury and Finance should undertake further inquiries, to ensure that, in relation to transactions with other central agencies, the GST is being charged correctly and that procedures are in place for determining what input tax credits are available.
Updating and enhancing of GST policies and procedures documentation	
3.54	All agencies should regularly review and update policies and procedures to ensure that they provide a sound and up-to-date source of information for staff involved in the administration of the GST.
Clarification of classification and reporting of grants and appropriations	
3.58	Action should be taken to ensure that key staff involved in processing GST data receive additional training on the classification of grants and appropriations, and the appropriate use of tax codes for these transactions.
Need for documentation of GST bad debt policies	
3.63	All agencies should ensure that GST policies and procedures are updated to incorporate reference to the treatment of bad debts.
Need for updated and ongoing staff training	
3.66	Agencies should implement a program of GST training to key staff on a regular basis.

Recommendations - continued

<i>Paragraph number</i>	<i>Recommendation</i>
Late attribution of GST transactions	
3.68	Action should be taken by all agencies to ensure the accurate recording of invoices and the timely recovery of input tax credits.
Lack of agreements for recipient created tax invoices (RCTI)	
3.71	Agencies should ensure that: <ul style="list-style-type: none"> • all RCTI arrangements are supported by formal agreements with relevant suppliers; • a register of all agreements be maintained; and • steps be taken to ensure that all invoices associated with these arrangements are generated and retained.
Claiming tax credits on invalid tax invoice documentation	
3.74	Ongoing training should be provided to staff to reiterate the requirements for valid tax invoices. A program of regular spot checks of relevant transactions may also assist in ensuring ongoing compliance by staff with policies and procedures for the processing of tax invoices.
Incorrect calculation of GST paid on certain invoices received	
3.76	Reconciliation processes should be strengthened to identify any discrepancies between prices as noted on the purchase orders and those ultimately charged on the tax invoices.
Issuing of invalid tax invoices	
3.79	Training programs should be targeted to ensure that staff do not generate invalid tax invoices.

Part 2

Payroll management

OVERVIEW OF THE AUDIT

2.1 In many organisations, payroll and other employee-related expenditure is the major component of the total financial resources consumed. The financial position of an organisation can be strongly linked to whether payroll expenditure is effectively planned, processed and managed. Effective payroll management plays a major role in maintaining a productive and motivated work force and is therefore, a key aspect of the overall human resource management process.

2.2 In the wider-context of financial and human resource management, the payroll function may encompass a significant range of issues and activities. This report is largely focused on the important aspect of ongoing management to ensure the accuracy, completeness and timeliness of the approval, calculation, payment and recording of payroll transactions.

2.3 A targeted audit of the payroll function was considered appropriate given:

- the materiality of payroll expenditure in the Victorian public sector with annual payments to employees and other employee-related payments totalling around \$9 billion, or 30 per cent of the State's total expenditure of \$30 billion;
- the risk that, despite its financial significance, agency management may place less emphasis on the control and oversight of payroll expenditure given the high volume, but low individual value of transactions; and
- the potential for fraud or misappropriation within poorly controlled payroll functions.

Outline of the audit process

Audit objectives

2.4 The key objectives of the audit were to:

- establish whether effective systems of internal control had been established for the payroll function within agencies;
- determine the extent to which controls had been complied with as part of the ongoing management and monitoring of payroll expenditure;
- assess whether the payment of salaries and related expenditure was made in accordance with relevant terms and conditions of employment; and
- identify better practices that could be applied by other agencies to improve the effectiveness of their payroll management.

Audit scope

Coverage of payroll during the annual financial statement audit process

2.5 The annual external audit of an agency does incorporate a review of transactions and balances related to payroll. However, the external audit process is primarily focused on forming an opinion on whether the annual financial report, based on the principles of materiality, fairly presents the financial operations and position of the agency as a whole. It does not necessarily give assurance that all individual categories of transactions and balances summarised in the financial report are appropriately controlled and accurately reported.

2.6 Given the restricted focus outlined above, the nature and extent of review of payroll during the annual audit process is dependent on consideration by the auditor of a range of factors, including:

- the relative risk associated with payroll in comparison with the other transactions and balances reported by an agency;
- the materiality of payroll transactions;
- the effectiveness of an agency's management and control environment;
- the adequacy of high-level controls associated with the payroll function; and
- the level of additional procedures deemed necessary to obtain assurance that any errors or omissions in payroll transactions and balances would not affect the audit opinion on the financial report of an agency.

2.7 Based on the preceding factors, the coverage of payroll may vary significantly across annual financial statement audits of individual agencies. In certain government departments, with large staff numbers and material payroll expenditure, the coverage may include detailed assessment and examination of payroll system controls with limited substantive testing of individual transactions. In agencies, where payroll expenditure is less material, the coverage may rely on a high-level control assessment and analytical review techniques with a lower emphasis on detailed evaluation and testing.

Scope of this review

2.8 Unlike considerations used in determining the scope of an annual financial statement audit, determining the coverage for this audit took into account the materiality of payroll expenditure and the risks associated with high volume, low value transactions. Accordingly, the scope of audit procedures was consistent across all agencies subject to review.

2.9 Specifically, the scope of the audit included assessment of:

- *payroll arrangements and systems* in place within agencies, including payroll software used, the extent to which administration of payroll had been decentralised and the level of outsourcing of the payroll function;

- the extent to which payroll processing integrity had been considered within the overall *risk management strategies* of agencies;
- the *control environment* established for payroll processing, including the existence of payroll policies and the effectiveness of delegations to undertake various aspects of the payroll function;
- *ongoing controls and processes* for administration of the various aspects of payroll from the appointment to the termination of an employee, including the quality of management information and reporting; and
- *monitoring and review functions* established for payroll transactions.

2.10 Procedures undertaken as part of the review included:

- review of legislation, government policies, agency policies and other requirements related to payroll;
- review of payroll documentation, systems and controls;
- discussions with agency management and staff; and
- testing of the application of identified controls and of specific transactions and procedures used in the payroll process.

2.11 The review was undertaken in the 17 government agencies outlined in Table 2A.

**TABLE 2A
AGENCIES SUBJECT TO DETAILED AUDIT REVIEW**

Parliament of Victoria
Department of Treasury and Finance
Department of Premier and Cabinet
Department of Human Services
Office of the Chief Commissioner of Police
Banyule City Council
State Revenue Office
Victorian Legal Aid Commission
Department of Justice
Department of Education and Training
Department of Infrastructure
Department of Innovation, Industry and Regional Development
Department of Natural Resources and Environment
Department of Tourism, Sport and the Commonwealth Games
Women's and Children's Health Service
Bayside City Council
Melbourne Exhibition and Convention Centre Trust

Audit criteria

2.12 Table 2B summarises the key criteria used to assess the effectiveness of payroll management in each of the areas included in the scope of the review.

**TABLE 2B
KEY SCOPE AREAS AND RELATED AUDIT CRITERIA**

<i>Key scope area</i>	<i>Key audit criteria</i>
Payroll arrangements and systems	<ul style="list-style-type: none"> • Analysis of the costs and benefits of various options for payroll administration should be undertaken. • Appropriate processes should be in place to manage outsourcing arrangements. • Computer software should be functional, appropriate to agency needs and up-to-date.
Risk management strategies	<ul style="list-style-type: none"> • Risks associated with personnel and payroll management should be considered as part of an agency's overall risk management strategy. • Risk assessments of the payroll function should consider, as a minimum, key risk areas such as overpayments, fraud and misappropriation. • Monitoring processes should exist to ensure that relevant risk strategies are being implemented.
Control environment	<ul style="list-style-type: none"> • A policy framework outlining the objectives, requirements and processes related to payroll should be in place. • Procedures should exist to ensure that all payroll policies are implemented and all risks are appropriately addressed. • Responsibility for all aspects of the payroll function should be clearly determined and allocated. • Staff involved in the payroll process should have appropriate experience, training and expertise.
Ongoing controls and processes	<ul style="list-style-type: none"> • Controls should be in place for all key aspects of the payroll process. • Adequate segregation of duties should exist for the processing, recording and payment of payroll transactions. • Sufficient consideration should be given to specific Information Technology Controls required for payroll applications.
Management information and reporting	<ul style="list-style-type: none"> • Processes should exist to ensure: <ul style="list-style-type: none"> • the accuracy and timeliness of payroll reports; • adequate consideration is given to payroll reports, variations and exceptions; and • appropriate reconciliations are performed between payroll and other financial systems.
Monitoring and review functions	<ul style="list-style-type: none"> • Regular monitoring and review processes should be in place to ensure the application of payroll policies.

Source: Victorian Auditor General's Office, with reference to the Australian National Audit Office's *Report No. 19, 2001-2002, Assurance and Control Assessment Audit, Payroll Management*.

Assistance provided to audit

2.13 My staff have indicated their appreciation for the co-operation and assistance provided by the management and staff of agencies included in this audit review.

2.14 Substantial reference was made during this review to material produced by the Australian National Audit Office (ANAO), including the audit criteria. This contribution by the ANAO is gratefully acknowledged.

PAYROLL ARRANGEMENTS AND SYSTEMS

Public sector environment for payroll management

2.15 Payroll and other employee-related expenditure and liabilities represent a major proportion of the total financial transactions in the majority of public sector and local government agencies. The complexity of payroll management and processes may also vary significantly between agencies. To illustrate these variations, Appendix 2A of this report summarises the characteristics of each of the agencies reviewed in this audit.

2.16 A key factor affecting the complexity of payroll management is the applicability of various legislation, industrial awards and employee agreements. For those agencies operating within the Budget sector of government, such as departments, employment conditions for the majority of employees may be covered by central legislation and awards for the public sector supplemented by local workplace agreements. However, certain departments and other agencies employ staff under a range of other awards and conditions. Examples of the legislation, awards and agreements that may be applicable to various agencies include:

- *Australian Workplace Relations Act 1996;*
- *Federal Workplace Reform Act 1996;*
- *Public Sector Management and Employment Act 1998;*
- *Financial Management Act 1994;*
- *State Superannuation Act 1998;*
- Victorian Public Servant Agreements;
- Victorian Government Schools Agreement 2001;
- Victorian Local Authorities Award 2001;
- the Nurses (ANF-Victorian Local Government) Award 1993; and
- various other legislative provisions, industry awards and workplace agreements relevant to specific categories of employees.

Audit findings

2.17 Central to the effectiveness of payroll management are decisions by agencies concerning the arrangements and systems to be implemented for the payroll function. In making these decisions, agencies should aim to implement the most cost-effective arrangements, suited to the specific environment and needs of an agency, while maintaining appropriate control over transactions. Specific matters for management to consider include:

- the extent to which responsibility for the approval and processing of payroll is centralised or delegated to business units or regional locations;
- the potential for outsourcing of payroll functions and the form of contractual arrangements with external service providers; and
- the computer software to be used for the payroll application.

2.18 To ensure that informed decisions are made and appropriately implemented for payroll arrangements, we would expect that agencies had:

- appropriately considered the impact on control of decentralisation of various aspects of the payroll function;
- implemented processes to ensure a consistent approach to payroll in a decentralised environment;
- access to information on the costs of payroll administration;
- a process in place for cost-benefit analysis of options for delivery of payroll services;
- established appropriate management processes for outsourced arrangements; and
- implemented payroll software that is functional, appropriate to agency needs and up-to-date.

2.19 Table 2C summarises the findings in relation to the criteria outlined above and some better practices identified.

**TABLE 2C
PAYROLL ARRANGEMENTS AND SYSTEMS,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED**

<i>Audit findings</i>
<ul style="list-style-type: none"> • In one agency, inconsistent practices were identified between regional locations with responsibility for initiating payroll transactions. • Delays in receipt of changes to payroll data from regional locations had resulted in a number of overpayments by one agency and additional costs associated with the recovery of these amounts. • In 7 agencies, the total administrative costs associated with the payroll function could not be identified. • Cost-benefit analyses had been undertaken by 11 of the agencies in recent years as part of their consideration of new payroll software or to assess the benefits of outsourcing aspects of payroll management. The remaining agencies had not undertaken analysis of alternative means of administering payroll.

TABLE 2C
PAYROLL ARRANGEMENTS AND SYSTEMS,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED - *continued*

<i>Audit findings - continued</i>
<ul style="list-style-type: none"> • While the results of analyses varied, 4 agencies had identified substantial financial and other benefits in outsourcing aspects of the payroll process. • Eight agencies continue to perform virtually all payroll functions in-house while the others had outsourced certain aspects of payroll processing and reporting to the private sector. By contrast, 2 agencies had outsourced virtually all functions for human services and payroll, with the exception of the approval process. • Agencies with outsourced arrangements appeared to have appropriate agreements with external providers in place. • One department expressed significant concerns over the quality of service of its provider in terms of out-of-date software and the integrity of data, and is in the process of resolving these issues. • Payroll software used by agencies was generally updated to implement current versions and address specific issues. • Difficulties were experienced by 2 agencies in modifying purchased software to suit the management of the specific leave conditions, such as recreation leave credits in advance and long service leave, available to employees within the Victorian public sector.
<i>Better practices identified</i>
<ul style="list-style-type: none"> • One agency conducts a cost-benefit analysis of payroll arrangements approximately every 2 years. • Agencies with substantial outsourcing had implemented detailed performance and service delivery criteria and financial penalties for non-performance of its external service providers. • Two agencies instigated an independent audit of outsourced arrangements, in part to verify the accuracy of performance information compiled by the external provider. • One agency had implemented an on-line system for employee pay advices and leave records. A number of other agencies were considering similar on-line facilities.

2.20 The complexity of payroll arrangements and systems varied significantly in the agencies reviewed due largely to the number of awards and agreements applying to agency employees and, in particular, the high level of decentralisation within several of the larger departments and certain other agencies.

2.21 Overall, agencies operating decentralised processes had implemented appropriate controls to address the potential risks that could eventuate in these environments. However, in one agency, delays in submission of information on leave, terminations and other payroll adjustments had resulted in overpayments or errors in payroll data that required additional administrative effort to correct.

2.22 Most agencies had reviewed the potential for outsourcing of at least certain functions of the payroll process. However, the actual level of outsourcing varied significantly across the agencies reviewed. Reliance on outsourcing arrangements was less prevalent in larger agencies with high employee numbers as it was often considered that it was more cost-efficient to maintain dedicated in-house resources to process payroll. Generally, these agencies had not performed detailed cost-benefit analyses to substantiate these views. Those agencies involved in outsourcing arrangements were generally satisfied with the service provided and, based on previous cost-benefit analysis and the ongoing monitoring of costs, considered that the arrangements resulted in efficiencies in payroll processing.

2.23 Eleven agencies had conducted a one-off cost-benefit analysis of alternatives to in-house resourcing of the payroll function, but had not established a process to periodically confirm that the decision emanating from this analysis remained the most cost-effective method of resourcing. In many agencies, the lack of costing information for internal resources involved in the payroll process represented a barrier to conducting periodic reviews.

2.24 Payroll software varied across agencies but was, in most cases, suitable to the processing requirements of each individual agency. Several agencies were in the process of implementing new software at the time of the audit. A particular issue noted was the difficulty experienced in adapting certain software to record the accrual of annual leave and long service leave entitlements in line with the specific policies and awards in operation within the public sector.

2.25 A range of better practices was identified in certain agencies. Of particular interest was the expanding use of on-line facilities to distribute pay and leave information to employees with the aim of enhancing employee access to this information and improving the efficiency of payroll processes.

Recommendations

2.26 We recommend that:

- agencies operating in a decentralised environment ensure that sufficient training and guidance is provided to all staff involved in the payroll process to resolve risks associated with inconsistent practices emerging between various agency locations and to minimise the incidence of errors arising from delays in processing changes in payroll data;
- all agencies implement a policy for periodic review of the costs and benefits of existing payroll administrative processes compared with potential alternatives; and
- based on benefits emerging in certain agencies, consideration be given by agencies to greater use of on-line facilities for dissemination of payroll information.

MANAGING PAYROLL RISKS

Overview of risk management

2.27 In the past, risk management has been an implicit aspect of organisational management in both the public and private sector. In recent times, in recognition of the increasing complexity and demands on organisations, increased emphasis has been placed on risk management as an explicit tool that enables systematic identification, evaluation and management of both risks and opportunities. This emphasis has included an increasing focus on the consideration of risks across all facets of an organisation's activities rather than being limited to financial risks.

2.28 Guidance on risk management is contained in a number of authoritative publications including:

- the 1995 Joint Australian/New Zealand Standard, AS/NZS 4360:1995 *Risk Management*;
- the 1999 updated standard and handbook, HB143:1999 *Guidelines for managing risk in the Australian and New Zealand public sector*; and
- the Commonwealth Government's *Guidelines for Managing Risk in the Australian Public Service*.

2.29 In the Victorian public sector context, aspects of risk management are referred to in various legislation and guidelines including the *Victorian Managed Insurance Authority Act 1996*, the *Financial Management Act 1994* and the Government's Management Reform Program. Consistent with these and national and international trends, many Victorian public sector entities are progressively implementing a more structured and systematic approach to risk management.

Risk management in a payroll environment

2.30 Risk management should include consideration of the risks associated with the payroll function, given its financial and operational significance in most organisations. Table 2D provides examples of risks that may require consideration in a payroll environment.

TABLE 2D
POTENTIAL RISKS IN A PAYROLL ENVIRONMENT

<i>Details of risk</i>	<i>Potential consequences</i>
Payroll personnel lack necessary experience, skill or knowledge to perform assigned functions.	Errors or under/overpayments may occur.
Resources used in payroll function are not minimised or outputs produced from resources are not maximised.	Increased administration costs.
Excessive elapsed time in performing payroll processes because of inefficient or unnecessary processes.	Delays in processing payroll transactions.
Payroll processes used do not comply with prescribed policies and procedures.	Incorrect or unauthorised payments. Overpayments.
Failure of payroll process may result in difficulties in continuing operations.	Dissatisfaction of management and employees relying on process.
Loss or incorrect reporting of payroll transactions and balances.	Incorrect financial statements. Incorrect leave balances. Increased costs to correct errors.
Staff either do things they are not supposed to do or fail to do things they should do.	Unauthorised transactions. Lack of clear roles and responsibilities. Lack of empowerment to act.
Personnel exceed the boundaries of their empowerment or authority.	Errors in payments and transactions. Unlawful deductions or payments.
Ineffective or inconsistent communications within the payroll function and across the agency.	Management remain unaware of problems. Inconsistent practices. Incorrect payments. Dissatisfied employees.
Inappropriate access to payroll systems and information.	Access to and use of confidential information. Lack of approval for payments and transactions. Corruption of data and files.
Lack of effective management of information technology infrastructure, systems, applications and processes.	System development and maintenance may not meet user needs. Inadequate security over systems and information. Corruption of data. Inaccurate management reports. Programming and processing errors. New employee details not accurately recorded.
Risk of fraud by employees resulting in loss or unauthorised use of information and assets.	Payments to non-existent employees. Unauthorised changes to data. Retention of terminated employees on systems.

Source: Victorian Auditor General's Office, with reference to the Australian National Audit Office's *Report No. 19, 2001-2002, Assurance and Control Assessment Audit, Payroll Management.*

2.31 As a minimum, potential risks of the type of outlined in Table 2D should be identified and analysed and, where required, actions to mitigate these risks should be included in a risk management strategy.

Audit findings

2.32 For effective risk management processes in relation to payroll, we expected that agencies had:

- established a co-ordinated framework outlining its approach to risk management;
- undertaken an assessment of risks associated with its key activities and had documented the results of its assessment in a risk management strategy;
- included consideration of the risks associated with personnel and payroll management as part of its overall risk management strategy;
- at a minimum, included consideration of key risk areas such as overpayments, fraud and misappropriation as part of its assessment of payroll risks; and
- established monitoring processes to ensure that relevant risk strategies, including those associated with payroll, are being progressively implemented.

2.33 Table 2E outlines audit findings in relation to these criteria and better practices identified.

**TABLE 2E
RISK MANAGEMENT,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED**

<i>Audit findings</i>
<ul style="list-style-type: none"> • Seven agencies had given little attention to date to adopting a formal approach to risk management. • Fraud management strategies had not been implemented in the majority of agencies. • Only 6 agencies had given attention to the specific risks associated with payroll. • Several agencies viewed the internal audit function as the primary means of identifying and reviewing risks.
<i>Better practices identified</i>
<ul style="list-style-type: none"> • Five agencies had adopted formal risk management policies, undertaken detailed risk assessments and developed specific risk management strategies. • Five agencies had installed a formal process for the regular review of the implementation of risk management strategies by audit or management committees. • One agency supplemented risk management processes at a corporate level by assigning responsibility for more detailed assessments to managers of business units, requiring these assessments to be updated annually and progress with actions to address risks to be reviewed by senior management on a quarterly basis.

2.34 Progress in implementing a systematic approach to risk management varied significantly with 5 agencies well advanced, others planning to implement a formal approach in the near future, while 7 agencies had given little attention to adopting a formal approach to risk management. Specific aspects of risk management had been addressed in all agencies, for example, through the development of disaster recovery or business continuity plans. Most agencies had not considered the development of a fraud management strategy, an area that should be given more prominence, particularly in view of the large sums of money at risk.

2.35 The nature of payroll risk assessments should be generally be directed at the process level to assist in determining the existence of effective controls and the level of compliance with these controls, and to identify potential for ongoing improvement to the payroll administration process.

2.36 Only 6 agencies had specifically considered the risks associated with the payroll function. In 3 of these agencies, payroll risks had been assessed but were considered to be low. One agency considered that the majority of risks associated with payroll had been passed to a service provider under an outsourcing arrangement. These agencies had also generally considered payroll at a corporate or strategic level rather than at a detailed process level. In other agencies, the risks of the payroll function had not been specifically considered due mainly to the absence of a fully developed approach to risk management.

2.37 Of concern was the view held in agencies that internal audit was the primary means of identifying and addressing risks, including those associated with the payroll. While internal audit represents an important component of risk management and its annual plans may be based on an assessment of risk, the internal audit process does not replace the responsibilities of management to maintain adequate controls over payroll processes.

Recommendations

2.38 We recommend that all agencies:

- adopt a formal and systematic approach to risk assessment in respect of the payroll function;
- consider the specific risks that may arise from the management of payroll; and
- ensure that responsibility for ongoing payroll risk management is clearly allocated to relevant management of the agency.

CONTROL ENVIRONMENT FOR PAYROLL

Features of a control environment

2.39 An effective control environment provides an effective framework for the management of an agency's operations and implementation of detailed controls and processes. The control environment assists in ensuring that detailed controls and processes, which address the requirements of legislation, government policy and management decisions, are appropriately implemented and consistently applied throughout an organisation. In relation to payroll management, the control environment should provide the framework for ensuring that payroll transactions are approved, accurate and complete.

Audit findings

2.40 To ensure that an effective control environment exists for payroll we expected that, as a minimum, agencies had:

- established a policy and procedural framework outlining the key objectives, requirements and processes related to payroll;
- clearly determined and allocated responsibility for all aspects of the payroll function;
- developed and documented the detailed procedures necessary to ensure that all payroll policies are implemented and all risks are appropriately addressed; and
- ensured that staff involved in the payroll function had appropriate experience, training and expertise.

2.41 In developing appropriate policies and procedures, agencies should consider a wide range of areas that may be relevant to the ongoing management of the payroll function. While not an exhaustive list of requirements, Appendix 2B of this report outlines a range of areas, which management should consider.

2.42 Table 2F summarises audit findings in relation to the payroll control environment and better practices identified.

**TABLE 2F
PAYROLL CONTROL ENVIRONMENT,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED**

<i>Audit findings</i>
<ul style="list-style-type: none"> • Virtually all agencies had established well developed and extensive documentation of policies and procedures for the payroll process. However, in one agency, documentation was outdated and was not used as a major reference source by staff. • All agencies had established formal procedures for approval of amendments to payroll policies and procedures. However, only 5 agencies had formal procedures for the systematic review and update of policies and procedures. The remaining agencies advised that policies were updated on a needs basis. • Agencies relied heavily on details regarding legislation, awards and other employment conditions contained on central agency websites as a source of information for payroll staff. • Eight agencies could enhance policy manuals through the development of additional procedural documentation. • Generally, all relevant staff were aware of the existence of policy and procedural documentation. • Certain agencies had not yet developed policies specific to the payroll function in relation to recent privacy legislation, or the use of email for the notification and approval of changes to payroll data. • Training of payroll staff was generally provided on a needs basis and to address new legislative or award requirements. Extensive reliance was placed on experienced staff to provide on-the-job training and development to other staff involved in the payroll function.
<i>Better practices identified</i>
<ul style="list-style-type: none"> • Certain agencies had implemented: <ul style="list-style-type: none"> • a process of annual review and update of key payroll policies; • detailed checklists to be followed by staff when processing various types of payroll transactions; • intranet and other on-line facilities to disseminate policy and procedural information to employees; and • policies for the use of email for approval processes.

2.43 Given the significance of payroll in the public sector, the findings that agencies had established an effective control environment should be expected. Our audit did, however, identify 12 agencies which did not have a systematic approach to the regular review of policies and procedures to ensure that they remained current. In these cases, reviews were only undertaken as issues were raised by staff, or on a needs basis as legislation and other regulations were amended. In one agency, policy documentation had not been updated for several years and was no longer used by staff as a major reference source. In this agency, staff relied on high-level policy documentation issued by central agencies and the knowledge and expertise of existing staff involved in the payroll process.

2.44 Enhancements could be made by agencies by the development of additional policy and procedural documentation where gaps currently exist. Specific areas to consider included:

- approval and processing of promotions;
- recovery of overpayments;
- changes to personal details of employees;
- roles and responsibilities of payroll staff; and
- implications of recent privacy legislation specifically related to the management of payroll data.

2.45 The use of email as a means of notification and approval of changes to payroll data was prevalent in most agencies reviewed. However, few agencies had developed specific policies concerning the use of email for these purposes. One agency had issued a policy specifically excluding the use of email for changes to payroll data following consideration of the additional risks associated with use of such facilities for approval processes.

Recommendations

2.46 We recommend that:

- all agencies implement a systematic approach for the regular review and update of payroll policies and procedures;
- where applicable, attention be directed to development of additional policy and procedural documentation to ensure that all key areas of the payroll process are addressed; and
- the use of email for approval of changes to payroll data be considered and supported by specific policy guidance.

PAYROLL CONTROLS AND PROCESSES

Importance of maintaining effective controls and processes

2.47 The existence of, and compliance with, detailed controls and processes for all aspects of payroll is of critical importance in ensuring the accuracy and completeness of payroll transactions. Failure to establish an effective control system increases exposure to a range of risks including:

- non-compliance with relevant legislative, award and policy requirements;
- inaccurate or inappropriate payments to employees;
- inaccurate calculation of taxation and other deductions;
- processing of transactions that have not been improved;
- incorrect recording of leave entitlements;
- errors in the recording of payroll transactions in financial records;
- inappropriate access to payroll information; or
- potential fraud or misappropriation of funds.

2.48 Ultimately, the emergence of these risks may have significant financial or reputational consequences.

2.49 Detailed control processes should be implemented for all aspects of the payroll function from the initial appointment of employees through until the termination of their employment. Appendix 2C of this report provides examples of potential control procedures for all key aspects of the payroll process.

Audit findings

2.50 In assessing the adequacy of control processes implemented by agencies, we considered that:

- controls should be in place for all aspects of the payroll process to ensure the accuracy, integrity and completeness of transactions;
- adequate segregation of duties should exist for the processing, recording and payment of payroll transactions;
- appropriate consideration should be given to the specific information technology controls required for payroll applications; and
- processes should exist to ensure the accuracy and timeliness of payroll reporting and the consistency of payroll information with financial records.

2.51 Table 2G outlines our audit findings against these criteria and better practices identified.

**TABLE 2G
PAYROLL CONTROL AND PROCESSES,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED**

<i>Audit findings</i>
<ul style="list-style-type: none"> • Overall, agencies had effective controls and processes in place in most areas of the payroll function to facilitate the approval, accuracy and completeness of payroll transactions. However, scope existed for enhancement of controls in certain areas such as reconciliation and monitoring processes and security over payroll documentation. • Appropriate segregation of duties between approval, processing and payment functions was noted in all agencies. • In most agencies, compliance with established controls was confirmed by audit testing. However, exceptions were noted in 2 agencies. In certain cases, these exceptions had resulted in errors in payroll data or the overpayment of employees. • In 3 agencies, there was no automatic interface between the payroll and general ledger system, thereby increasing the risk of errors of incorrect compilation and recording of financial data.
<i>Better practices identified</i>
<ul style="list-style-type: none"> • One agency has an on-line facility for approval of leave and issue of payslips, which provides improved access by employees to relevant information and reduces administrative costs.

2.52 All agencies had instituted systems of internal control aimed at ensuring the accuracy and completeness of payroll data. However, agencies could enhance control processes by:

- greater emphasis on the production and review of payroll exception reports as a means of overseeing unusual transactions and potential errors in payroll data;
- implementation of formal checks to ensure the correct versions of payroll data files were used in payroll runs;
- detailed reconciliations of transaction totals between payroll and other financial systems and records. These are considered of increased importance where there is no automatic interface between payroll and other system applications;
- the physical security over payroll documentation to prevent unauthorised access to information;
- the recording and review of complaints and overpayments as a means of identifying the extent of these issues, ensuring resolution and to allow consideration on whether trends in complaints and overpayments are indicative of endemic problems in the payroll system; and
- adequate password security to prevent unauthorised access to the payroll system and reduce the risk of unauthorised changes to payroll data or applications.

2.53 The existence of, and compliance with, controls and processes was confirmed by audit review and testing in most agencies. In 2 agencies, exceptions were noted in sample transactions selected for audit testing including:

- incomplete or inaccurate employee pay information held on personnel files;
- inconsistencies between rates used in pay calculations compared with those recorded in personnel information;

- missing personnel files;
- delays in finalisation of termination documentation;
- lack of approval of leave applications; and
- incomplete certification by business units of payroll details.

2.54 A major issue identified in one agency was a substantial level of errors made when calculating new pay rates when implementing general pay increases for employees culminating in a number of overpayments and an increased administrative effort necessary to recover these amounts. Errors of this nature are indicative of insufficient attention directed to independent checking of changes to pay rates prior to processing and payment, a control of particular relevance at times of significant changes to payroll data.

Recommendations

2.55 We recommend that agencies:

- undertake periodic reviews of control processes to ensure that they remain appropriate in ensuring the validity and accuracy of payroll transactions;
- strengthen controls in areas such as checking versions of payroll files, reconciliation of payroll totals to other financial records and the security of payroll information;
- consider greater use of exception reporting as a key method of oversight for changes to payroll data, exceptional or unusual transactions and the reasonableness of amounts processed and recorded;
- implement additional control procedures and consider additional staff training to minimise errors or exceptions identified in payroll processing; and
- pay particular attention to existing controls or the implementation of more stringent processes to address the additional risk of error that arises at times of substantial change to payroll data, such as the processing of general award rises for large numbers of employees.

MONITORING AND REVIEW OF PAYROLL

Overview of monitoring and review processes

2.56 Monitoring and review processes involve the oversight of the payroll function to provide assurance to management that approved controls and processes are operating effectively and efficiently. While personnel directly involved in the payroll function will undertake these processes, independent monitoring and review is an important additional feature of an effective approach to monitoring and review.

2.57 Examples of monitoring and review processes that agencies may employ for payroll include:

- registering and investigation of complaints and overpayments;
- performance measurement of the efficiency of the delivery of payroll services;

- benchmarking against similar organisations;
- internal audit reviews;
- certification of payroll data by management of business units or regional centres;
- staff satisfaction surveys; and
- quality assurance processes.

Audit findings

2.58 In evaluating the effectiveness of monitoring and review processes, we considered that all agencies should have adopted a formal approach to regular monitoring and review to ensure that payroll policies and procedures are complied with, and to identify changes and weaknesses in the payroll operating environment. This approach should incorporate procedures that any issues emanating from monitoring and review processes are appropriately acted upon and resolved.

2.59 Table 2H summarises the findings and better practices identified in relation to the criteria outlined above.

**TABLE 2H
MONITORING AND REVIEW OF PAYROLL,
AUDIT FINDINGS AND BETTER PRACTICES IDENTIFIED**

<i>Audit findings</i>
<ul style="list-style-type: none"> • Internal audit: <ul style="list-style-type: none"> • all agencies reviewed had established an internal audit function; • the nature and extent of internal audit coverage within agencies varied significantly; and • in the majority of agencies, an internal audit review of payroll activities were scheduled on a cyclical basis. However, in a small number of agencies, an internal audit review of payroll had not been undertaken for several years. • All organisations had formal processes for ensuring action had been taken by management on issues raised by internal audit. • Most agencies had given limited attention to the implementation of other independent monitoring and review processes such as performance measurement, benchmarking, staff surveys or independent certification of payroll data. • Only 3 agencies had established registers of complaints and overpayments as a means of determining the accuracy of payroll processing.
<i>Better practices identified</i>
<ul style="list-style-type: none"> • Better practices utilised by agencies included: <ul style="list-style-type: none"> • implementation of a range of performance indicators to monitor the efficiency and timeliness of payroll processing; • regular meetings of user groups to identify issues and provide suggestions for improvements to processes; • inclusion of feedback on the payroll process as part of performance review meetings with individual staff; • benchmarking with similar interstate organisations; and • regular certification by business unit management of the accuracy of payroll details. • One agency had acquired ISO 9002 certification and used the ongoing certification process as a means of ensuring that all policies and procedures relating to human resources and payroll were kept current.

2.60 The internal audit function is a key method for providing assurance over both operational and financial activities. As indicated in the preceding table, all agencies had internal audit functions.

2.61 In the high volume transaction environment existing for payroll, internal audit can play a major role in ensuring that controls have been applied and that payroll has been accurately and completely processed. It was, however, noted that the extent of internal audit coverage of payroll varied significantly between agencies from:

- annual coverage of payroll activities included in internal audit plans;
- a cyclical approach to the review of payroll; and
- a range of ad hoc reviews of specific aspects of the payroll function.

2.62 Of concern was that in some agencies, an internal audit review of payroll activities had not been undertaken for several years and was not based on an assessment of the risks associated with the payroll function.

2.63 The scope of internal audit coverage of payroll also varied with reviews in some agencies concentrated on high-level control reviews and less focus on assessment of detailed controls and procedures or testing and verification of individual payroll transactions.

2.64 We noted that one agency had extensively used internal audit to review the performance of its external service provider and compliance with the terms of contractual arrangements. Because of this review, management has gained substantial assurance over the controls and processes implemented by the provider while identifying a number of areas that would enable it to further improve the benefits generated by this outsourced arrangement.

2.65 Certain agencies had adopted a range of other monitoring and review processes to provide additional assurance to management over payroll operations. The better examples included a range of processes and activities conducted independently of payroll personnel, such as the periodic certification of payroll data by business unit managers, the oversight of payroll variations and feedback by users.

2.66 The use of performance indicators and benchmarking is an important method of monitoring the efficiency of payroll and other administrative activities. A small number of agencies had established detailed performance indicators to monitor the efficiency of payroll processing while one agency had taken action to benchmark its payroll operations against similar interstate organisations. However, substantial scope existed across agencies for greater use of performance indicators and benchmarking. The Australian National Audit Office's *Audit Report No. 62, 2001-2002, Benchmarking the Finance Function*, details a range of benchmarks that could be used in assessing and comparing the efficiency of agency payroll functions, as summarised in Table 2I.

TABLE 2I
PAYROLL ACTIVITY BENCHMARKS

<i>Dimension</i>	<i>Benchmark formula</i>
Cost - overall	Total payroll activity cost/Total organisational expenditure
Cost - per activity	Total payroll activity cost/Annual number of pays
Efficiency	Total number of pays annually/Full-time equivalent employees involved in the payroll activity
Quality - error rate	Total number of pays with errors/Total number of pays annually

Source: Australian National Audit Office, Audit Report No. 62, 2001-2002, Benchmarking the Finance Function.

2.67 A key deficiency in the majority of agencies reviewed was the lack of a formal approach to registering and resolution of complaints by staff and overpayments. Recording and monitoring of the incidence of complaints and overpayments can provide a key indicator to management on the extent to which control processes are in operation and the accuracy of payroll transactions. However, many agencies considered that incidence rates were low and could be resolved by payroll staff without formal recording or monitoring.

Recommendations

2.68 We recommend that:

- all agencies should ensure that, at a minimum, key payroll functions are subject to internal audit review on a cyclical basis;
- agencies adopt a more systematic and formal approach to other monitoring and review activities, which would provide management with ongoing assurance over the accuracy and completeness of payroll processing and the efficiency of payroll administration; and
- consideration be given by agencies to the implementation of benchmarks for the payroll function using comparative information of their performance against benchmarks achieved by comparable agencies.

Part 3

Administration of the goods and services tax

INTRODUCTION OF THE GST

3.1 The Commonwealth Government's *A New Tax System (Goods and Services) Act 1999* introduced major changes to the Australian tax system, including amendments to the "pay-as-you-go" and fringe benefit taxation systems. However, the major impact of this legislation was the introduction of a goods and services tax (GST) from 1 July 2000.

3.2 The GST is a broad-based tax levied, at the rate of 10 per cent, on the supply of the majority of goods and services consumed within Australia. In practice, the GST is aimed at taxing value added at each level of the supply chain with the tax borne by the ultimate consumer of goods or services. Generally, entities registered for GST purposes are entitled to an input tax credit for the GST included in the price paid for goods and services used in carrying out their business.

3.3 A range of goods and services has been exempted from the imposition of GST, including health, education, the majority of food items, childcare, water and sewerage services, and exported goods and services. Some goods and services are input taxed, that is, there is no entitlement to input tax credits incurred on acquisitions used in making such supplies. Examples of input taxed supplies include financial services and residential rent.

3.4 Under the Commonwealth legislation, State Governments are subject to the same GST requirements as the private sector.

3.5 The implementation of the taxation reforms resulted in significant changes to previous funding and taxation arrangements. Financial assistance grants, previously provided to the States and Territories by the Commonwealth were abolished and replaced by the distribution of GST revenue to the States and Territories, while the Commonwealth Government's wholesale sales tax and certain indirect State taxes were abolished. To give effect to these changes, the Commonwealth, States and Territories entered into an Intergovernmental Agreement on the Reform of Commonwealth – State Financial Relations (IGA) in June 1999.

Audit objectives

3.6 The objectives of our review were to:

- assess the effectiveness of the State's taxation compliance assurance framework as a tool for managing the State's risks in complying with GST requirements;
- ascertain the extent to which individual public sector agencies are complying with the State directions and rules established under the State's tax compliance assurance framework for the GST;
- review the effectiveness of policies and processes within individual public sector agencies to implement, control and manage GST requirements; and
- review the level of compliance by individual agencies with Commonwealth legislative and Australian Taxation Office requirements relevant to the GST.

Audit scope

3.7 The review included assessment of:

- the effectiveness of the State’s tax compliance assurance framework;
- the extent to which agencies are complying with Ministerial Directions and rules governing taxation compliance and monitoring;
- identification of the key risk areas for GST compliance within specific departments and agencies;
- policies and systems within agencies to manage and monitor GST including:
 - the effectiveness of the control environment implemented for processing GST transactions;
 - the adequacy of specific controls implemented to manage Business Activity Statement (BAS) processes and GST requirements of the expenditure and revenue cycles; and
 - the effectiveness of monitoring and review processes implemented in relation to GST; and
- the level of compliance for individual financial transactions by agencies with GST requirements.

3.8 The review was undertaken at the Parliament of Victoria, all Victorian Government departments and the Office of the Chief Commissioner of Police. A list of all agencies is shown in Table 3A.

**TABLE 3A
AGENCIES INCLUDED IN THE REVIEW OF ADMINISTRATION OF GST**

Parliament of Victoria
Department of Premier and Cabinet
Department of Treasury and Finance
Department of Natural Resources and Environment
Department of Education and Training
Department of Human Services
Department of Infrastructure
Department of Justice
Office of the Chief Commissioner of Police
Department of Innovation, Industry and Regional Development (a)
Department of Tourism, Sport and Commonwealth Games (a)

(a) The Department of Innovation, Industry and Regional Development and the Department of Tourism, Sport and the Commonwealth Games were created during 2001-2002 largely from a split of the functions of the former Department of State and Regional Development. The 2 new departments operated a single, integrated accounting system in the period under review, and a single Business Activity Statement incorporating the activities of both departments was lodged each month during this period. Accordingly, for the purposes of this review, the 2 departments were considered as a single entity.

Audit methodology

3.9 The primary focus of the review was to assess the quality of the controls and review the mechanisms in place to ensure compliance with the GST legislative provisions. In making this assessment, key steps of the review included:

- discussions and interviews with relevant departmental personnel;
- examination of relevant files supporting GST processing activities;
- identification, observation and inspection of GST processing controls in place;
- testing of transactions, selected using a statistical sampling methodology, to assess whether the GST had been correctly calculated and transactions had been processed accurately in accordance with legislative and procedural requirements;
- review of BAS preparation procedures to confirm the existence and adequacy of the audit trail by undertaking a detailed review of a BAS for a predetermined tax period, including examination and review of relevant documentation including edit and exception reports; and
- confirming the existence of appropriate processes to define relevant training needs.

Assistance provided to audit

3.10 The majority of work associated with the audit was undertaken by Deloitte Touche Tohmatsu under contract to my Office.

3.11 Appreciation is expressed for the co-operation and assistance provided by the management and staff of agencies included in this audit review. A report on the results of the audit undertaken in each agency was provided to the agency.

3.12 Substantial reference was made during this review to material produced by the Australian National Audit Office (ANAO). This contribution by the ANAO is gratefully acknowledged.

ARRANGEMENTS FOR THE GST IN THE VICTORIAN PUBLIC SECTOR

3.13 Under Commonwealth taxation legislation, entities are required to register for an Australian Business Number (ABN) to avoid the provisions of “pay-as-you-go” legislation relating to the withholding of amounts from payments to creditors. Government agencies, although not required to be registered for GST, may choose to register. Where registered for GST, all entities must lodge monthly or quarterly Business Activity Statements (BAS), with the frequency of lodgement dependent on annual turnover.

3.14 While the legislation allows for registration in a government sector of a single entity at a Crown or “whole-of-government” level, it does not preclude the separate registration of individual public sector entities.

3.15 The Victorian Government has adopted a policy that all Victorian public sector departments and agencies must register for an ABN where so entitled or required, and must separately register for the GST, irrespective of the requirements of the registration threshold, unless there is a compelling reason which would make GST registration uneconomic.

3.16 As a consequence of the Victorian Government's registration policy, the introduction of the GST and other taxation reforms has placed significant responsibilities on both central and other public sector agencies, many of which had limited prior exposure to the management of indirect taxation requirements.

3.17 To meet these responsibilities, substantial effort was devoted by departments and agencies during the implementation phase of the GST regime to the management of a range of issues, including implementation planning, upgrading of financial systems and processes, resolving taxation issues for specific transactions, such as grants and subsidies and prior contractual arrangements continuing after GST implementation, and the development of taxation expertise. Many agencies used extensive external expertise to assist in managing these implementation issues or to provide independent assurance of their preparedness for the introduction of GST requirements.

3.18 The Department of Treasury and Finance played a lead role in assisting agencies with the implementation of the GST regime. Initially, this role was mainly aimed at resolving various transitional issues following the initial introduction of the GST or arranging independent assessments of the planning and implementation processes adopted by agencies. In more recent times, the Department has directed greater attention to the ongoing management of the taxation requirements of public sector agencies.

Implementation of a tax compliance framework for public sector agencies

3.19 A major initiative of the Department of Treasury and Finance was the development and implementation in 2001 of a tax compliance framework for the Victorian public sector.

3.20 The tax compliance framework is an assurance and accountability mechanism aimed at setting standards for compliance with all Commonwealth taxation requirements, including the GST. The compliance framework is to be followed by all public sector agencies.

3.21 Under the framework, ultimate accountability for tax compliance has been assigned to the management of each individual agency. Each government department is also expected to perform a high-level assurance role over compliance by agencies within their portfolio, while the Department of Treasury and Finance maintains a role in monitoring taxation compliance at a Statewide level.

3.22 Key components and features of the tax compliance framework are summarised in Table 3B.

**TABLE 3B
FEATURES OF THE STATE'S TAX COMPLIANCE FRAMEWORK**

<i>Component</i>	<i>Features</i>
Ministerial Directions	Require accountable officer of each State Government agency to comply with Commonwealth taxation requirements and rules and guidelines established in the tax compliance framework.
Rules and monitoring arrangements	Establishes rules and policies to be followed by State Government agencies for registration under Commonwealth legislation, tax planning, technical compliance and the ongoing management of various taxation-related issues.
Administrative guidelines	Outlines the roles and accountabilities under the taxation framework at a whole-of-government, portfolio and individual agency level. Details the processes to be followed for the certification, reporting, monitoring, review and management of taxation compliance.
Tax compliance review checklist	Provides a detailed checklist to assist agencies in their review of controls and management of risks associated with taxation compliance.

Source: Tax compliance framework for the Victorian public sector.

3.23 The Department of Treasury and Finance has also implemented a program of independent assessments, on a cyclical basis, of the level of compliance by agencies with the requirements of the framework with reviews of around 30 individual agencies to be undertaken annually. This program commenced in 2001-02.

3.24 The development of the tax compliance framework is a major initiative of the Department of Treasury and Finance. By outlining key responsibilities and accountabilities for all public sector agencies, the framework is an effective mechanism to facilitate ongoing compliance by Victorian public sector agencies with Commonwealth taxation requirements. A key task of the Department will be to ensure that the framework is continually updated and enhanced to address the implications of emerging taxation issues and new rulings by the Australian Taxation Office.

COMPLIANCE BY DEPARTMENTS WITH GST REQUIREMENTS

Method of testing for compliance

3.25 A key objective of the audit was to assess the level of compliance by individual agencies with Commonwealth legislative and Australian Taxation Office requirements for the GST. To meet this objective, a selection of transactions were examined to assess whether the GST had been correctly calculated and transactions had been processed accurately in accordance with legislative and procedural requirements.

3.26 Victorian Government departments are, in the main, large with a high volume of transactions and related GST activity, as summarised in Table 3C for the period subject to review (1 July 2001 to 31 May 2002).

TABLE 3C
VOLUME OF TRANSACTIONS AND GST ACTIVITY,
1 JULY 2001 TO 31 MAY 2002

<i>Agency</i>	<i>Transactions</i>	<i>Input tax credits</i>	<i>GST payable on outputs</i>
	<i>(no.)</i>	<i>(\$'000)</i>	<i>(\$'000)</i>
Department of Education and Training (DET)	945 542	89 186	3 013
Department of Human Services (DHS)	774 326	571 805	426
Department of Treasury and Finance (DTF)	519 744	28 031	11 658
Department of Justice (DOJ)	288 221	26 453	2 529
Department of Premier and Cabinet (DPC)	91 163	18 042	511
Department of Natural Resources and Environment (DNRE)	273 908	50 348	15 609
Office of Chief Commissioner of Police (OCCP)	166 995	26 207	1 609
Department of Infrastructure (DOI)	95 135	96 008	5 676
Department of Innovation, Industry and Regional Development and Department of Tourism, Sport and Commonwealth Games (DIIRD & DTSCG)	62 997	11 748	1 262
Parliament of Victoria (POV)	45 070	2 068	192

Source: As advised by departments and agencies.

3.27 The large volume of transactions in each department necessitated the use of statistical sampling methodology for substantive testing of the level of compliance with GST requirements. Application of this methodology resulted in a selection of 160 transactions for examination in each agency from the total population of transactions, for the period 1 July 2001 to 31 May 2002.

Results of audit examinations

Errors identified in selected transactions

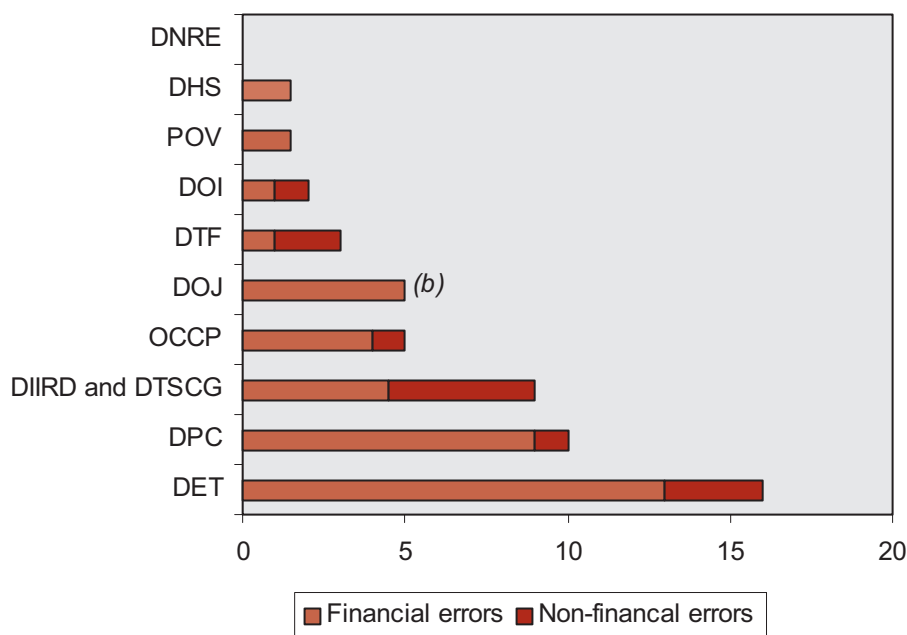
3.28 Examination of the transactions selected was directed at assessing whether transactions had been processed accurately and in accordance with legislative and procedural requirements for the administration and payment of the GST.

3.29 Our audit confirmed that all agencies subject to review had a range of controls in place to ensure compliance with GST requirements, ensure the accuracy of data processing related to GST and maintain appropriate audit trails for the GST transactions.

3.30 Despite the existence of these control mechanisms, the audit identified error rates in the 160 transactions examined in each agency of between approximately one and 16 per cent with no errors identified in respect of one agency.

3.31 Chart 3D shows that a large proportion of the errors were financial in nature, which may impact on the accuracy of the amount of GST paid or input tax credits claimed. The remaining errors were non-financial, such as the incorrect dissection of capital and non-capital items, which may impact on the integrity of BAS reporting to the Australian Taxation Office but do not affect the amount of GST payable.

CHART 3D
PERCENTAGE OF ERRORS IDENTIFIED, BY AGENCY (a)
 (per cent)



(a) Refer to Table 3C for explanation of agency abbreviations.

(b) The population from which a sample was selected at the Department of Justice excluded approximately 6 000 capital transactions made between July 2001 and May 2002.

Note: Percentage of errors based on number of errors identified as a percentage of 160 transactions examined in each agency.

Source: Victorian Auditor-General's Office.

3.32 The majority of errors identified during the audit examination could be classified into 3 categories, namely:

- issues associated with assessment by agencies of whether suppliers' invoices complied with the requirements of GST legislation to enable claims to be made for input tax credits;
- the adequacy of processes for dealing with invoices where issues of non-compliance were identified; and
- the incorrect coding of a GST transaction.

3.33 The majority of these errors could be addressed through additional training of personnel involved in GST administration.

3.34 As indicated in Chart 3D, the Department of Education and Training had the highest error rate of 16 per cent. This higher rate was mainly due to 19 transactions considered as errors because source documentation was not provided to support classification of these transactions for GST purposes. The key issue related to whether the payments were in the nature of grants, on which GST is payable, or government appropriations, which do not attract GST. The Department has recognised the need for clarification of this issue as a matter of priority and has commissioned consultants to undertake a review of a sample of grant payments. Further details of this and other issues identified and recommendations for improvement are outlined in subsequent Parts of this report.

Implications of error rates

3.35 Attribute statistical sampling methodology can be used as a basis for estimating the likelihood of errors in the entire population of GST transactions within agencies. Based on the results of our examinations, at a confidence level of 80 per cent, the estimated true population error rate for GST transactions may range from nil per cent in the Department of Natural Resources and Environment to between 12.3 per cent and 19.7 per cent for the Department of Education and Training. Table 3E outlines the estimated ranges of the true error rate for each of the agencies reviewed.

TABLE 3E
ESTIMATED RANGES OF TRUE ERROR RATES, BY AGENCY

<i>Agency (a)</i>	<i>Transactions in review period</i>	<i>Error rate in sample</i>	<i>Estimated range of true error rate in population using 80% confidence level</i>
	<i>(no.)</i>	<i>(%)</i>	<i>(%)</i>
DET	945 542	16	12.3 to 19.7
DPC	91 163	10	7.0 to 13.0
DIIRD and DTSCG	62 997	9	6.1 to 11.9
OCCP	166 995	5	2.8 to 7.2
DOJ	288 221	5	2.8 to 7.2
DTF	519 744	3	1.3 to 4.7
DOI	95 135	1.25	0 to 2.5
DHS	774 326	1	0 to 2.0
POV	45 070	1	0 to 2.0
DNRE	273 908	0	n.a.

(a) Refer to Table 3C for explanation of agency abbreviations.

Source: Victorian Auditor General's Office.

3.36 While useful for estimating the error rate within a population, the use of attribute sampling cannot be used as a tool for predicting the financial impact of other errors existing in the entire population of transactions. Accordingly, while the nature of errors identified during the sample testing was considered relatively minor and did not result in significant financial errors, the financial magnitude of other errors that may exist in GST transactions within agencies cannot be established from this review.

3.37 Overall, while potential error rates in certain agencies could be considered relatively high, many of the errors identified were similar in nature and had resulted from deficiencies in administrative processes operating for the management of the GST. Action by the relevant agencies to improve processes in these areas may significantly reduce the risk of errors in future GST transactions.

3.38 Appendix 3A of this report provides further details of the sampling methodology used in the audit and the potential implications of error rates identified during the examination using various confidence levels.

CONTROLS AND PROCESSES FOR ADMINISTERING THE GST

Introduction

3.39 In addition to the substantive examination of selected GST transactions, assessments were undertaken of agency processes to ascertain whether:

- risk assessments used to identify, assess and manage GST risk were adequate;
- an adequate control environment with specific controls and processes related to activities associated with the Business Activity Statement (BAS) and the GST requirements of accounts payable and accounts receivable cycles had been established;
- appropriate management information concerning the GST was maintained and communicated to the right people at the right time; and
- monitoring and review processes in place for the management of the GST were effective.

3.40 During our examination of selected transactions, attention was directed to the adequacy of controls and processes in 4 key areas; namely, the BAS preparation process, the management of accounts payable, the management of accounts receivable and the management of cash flows associated with the GST.

Effectiveness of the GST controls and processes

3.41 Based on audit examination and review, we concluded that controls and processes for the GST were functioning efficiently in each of the agencies subject to review. Our observations revealed that agencies reviewed had strong controls in each of the key areas included in the scope of the review.

3.42 Key features common to the GST processes implemented by agencies included:

- Establishment of an effective control framework to support GST transactions and BAS reporting;

- The use of a number of reasonableness calculations as part of the BAS preparation process to ensure the information being lodged with the Australian Taxation Office (ATO) was reasonable;
- Post-implementation GST reviews and introduction of policies and processes to ensure compliance with the Department of Treasury and Finance's Tax Compliance Framework;
- Assigning GST responsibility to an individual or group to ensure effective GST management;
- Most agencies trained staff and managers in GST processing and compliance matters during implementation;
- All agencies reported a significant regular net GST refund position to the ATO. Most agencies had implemented mechanisms to leverage cash flow, e.g. most had considered early submission of the BAS in order to create a cash flow advantage; and
- All agencies used their financial accounting software to generate GST data with limited manual input required to complete BAS reporting.

3.43 Many of the management and control processes used by the agencies examined were considered to represent better practices for GST administration. Ensuring that similar practices are implemented across other public sector agencies may be beneficial in improving the quality of GST administration throughout the Victorian public sector. Appendix 3B of this report provides further details of better practices identified during the audit.

Potential for improvement in controls and processes

3.44 Our examination of transactions and assessment of controls and processes revealed a number of issues occurring either within individual agencies or across agencies which offer potential for improvement to current GST-related controls and processes. Table 3F summarises issues identified during the review with further details provided in subsequent paragraphs.

**TABLE 3F
SUMMARY OF SPECIFIC GST MANAGEMENT ISSUES**

<i>Issue</i>	<i>No of agencies issue applies to</i>
Need for clarification of treatment of financial supply transactions administered on behalf of the public account.	1
Clarification of classification and reporting grants and appropriations.	8
Updating and enhancing GST policy and procedural documentation.	8
Need for documentation of GST bad debt policies.	7
Need for updated and ongoing staff training.	4
Late attribution of GST transactions.	3
Lack of agreements for recipient created tax invoices.	3
Claiming input tax credits on invalid tax invoice documentation.	2
Incorrect calculation of GST paid on certain invoices received	2
Issuing of invalid tax invoices.	1

Need for clarification of treatment of financial supply transactions

3.45 Public Account investments are managed by the Victorian Funds Management Corporation (VFMC), which invoices the Department of Treasury and Finance (DTF) on a quarterly basis for fund management fees and on a monthly basis for custodian and other professional fees. VFMC operates under mandatory guidelines as to which assets it can invest in. These are fixed interest Commonwealth and Semi-Government Bonds and corporate bonds, with a 5 per cent cash balance. The investment turnover is low as most bonds are held to maturity, however, interest is received on a regular basis and advised to DTF. These transactions are reflected in the State's consolidated account but are not shown in the accounting records of DTF for BAS purposes.

3.46 The Treasury Corporation of Victoria (TCV) manages the State borrowings. TCV charges a fee for the services it provides for managing borrowings but no GST is charged by the TCV on these fees. However, in contrast, GST is charged by the TCV for other consultancy work it undertakes for DTF. Where the TCV charges the GST for these consultancy fees, this is claimed as an input tax credit through the business activity statement of DTF.

3.47 A risk exists that transactions of the nature referred to above may result in DTF claiming the GST where there is no entitlement to a full input tax credit. Under relevant taxation legislation, expenditure for services classified as financial supplies and where the agency exceeds the financial acquisitions threshold there is either no entitlement to an input tax credit or a 75 per cent entitlement if the acquisition qualifies as a reduced credit acquisition.

3.48 DTF should undertake further enquiries, including consultation with the ATO, to ensure that the GST is being charged (or offset by input tax credit) correctly and that procedures are in place for determining what input tax credits are available in relation to transactions with the VFMC, the TCV and the Government Superannuation Office.

3.49 DTF has advised that it has engaged consultants to review the nature of these transactions and to ascertain whether the appropriateness of GST calculations currently made by DTF for these transactions.

Updating and enhancing of GST policies and procedures documentation

3.50 Documentation of GST policies and procedures, that are sufficiently specific to the activities of an entity, reduces the risk of errors and/or omissions in the preparation of relevant tax information. Such errors or omissions may ultimately lead to a potential exposure to penalties if an outstanding GST liability eventuates. Accordingly, documentation should be specifically tailored to the activities and transactions of each agency. Documentation of new and existing GST policies and procedures should also be monitored on an ongoing basis to ensure that it remains up-to-date as GST legislation and associated rulings change or emerge.

3.51 The need to have accurate and useful GST documentation that is continually updated becomes even critical as changes in personnel responsible for GST administration eventuate. Appropriate documentation provides new staff with access to reference information concerning the GST profile of an organisation and its policies and procedures.

3.52 All agencies reviewed had developed and documented GST policies and procedures. In certain agencies, GST documentation comprised very detailed manuals outlining the agency's GST control environment and covered areas such as GST rules, tax invoice requirements, relevant tax codes, and treatment of specific transaction types.

3.53 A range of issues were, however, identified in certain entities in relation to GST policy and procedure documentation. These issues were:

- in the majority of entities, GST policies and procedures had not been updated since June 2000;
- certain GST rulings made by the ATO, dating back to April 2000, had not been included in GST documentation;
- relevant tax codes, the circumstances in which they should be used and journal entries required to give effect to certain transactions had not always been documented;
- the treatment and consequences of certain unusual or ad hoc transactions, for example transactions involving non-monetary consideration (barter transactions) and export supplies, were not documented; and
- documentation of procedures associated with BAS preparation and reconciliation processes was generally not well detailed and did not sufficiently document all processes undertaken for completing the BAS.

3.54 While action has commenced in certain entities to update and enhance policy and procedures documentation, all entities should regularly review and update policies and procedures to ensure that they provide a sound and up-to-date source of information for staff involved in the administration of the GST. In addition, steps should be undertaken to ensure that documentation adequately addresses all GST policies and procedures including:

- the GST consequences of any ad hoc transactions arrangements to assist staff in processing such transactions; and
- the process, reconciliation procedures, time frames and sign-off process to facilitate the BAS preparation process and to ensure that the BAS can be completed, should the staff member who normally prepares this be absent or leave the agency.

Clarification of classification and reporting of grants and appropriations

3.55 General taxation rules provide that the GST applies to the payment of grants but does not apply to the payment of government appropriations. The criteria for determining the classification of such payments is set out in legislation supplemented by a ruling by the ATO. To meet the legislative definition of an appropriation, a payment must be made by a government-related agency to another government related agency and the payment must be covered by an appropriation under Australian law.

3.56 If the requirements for an appropriation payment are met, the payment is considered to be outside the scope of the GST; that is, it is not considered to be a supply for GST purposes and does not need to be reported in the BAS. However, where the payment does not fit the definition of an appropriation and is consideration for the supply of goods or services, it may be more appropriately classified as a “grant”. Generally, the GST must be included in the grant amount at the rate of 10 per cent. The entities receiving the grant must collect the GST included and remit this to the ATO while the agency providing the grant would claim an equivalent amount as an input tax credit.

3.57 There remains a lack of clarity within agencies regarding the classification of appropriations grants and other payments, the correct GST treatment to be applied and documentation to be collected and/or supplied for these transactions. In some entities, certain appropriation transactions had been incorrectly coded and reported in the BAS even though reporting of these items was not required. Although the Statewide GST implications are nil in financial terms, the inclusion of such transactions in the BAS may distort amounts reported to the ATO.

3.58 Action should be taken to ensure that key staff involved in processing GST data receive additional training on the classification of grants and appropriations and the appropriate use of tax codes for these transactions to ensure that the BAS is completed in accordance with ATO instructions.

3.59 As an example, the Department of Education and Training makes payments to schools, universities and TAFES for the provision of educational services and facilities. Due to the fact that such payments are in essence made to support the provision of education, the Department has classified these payments as “appropriations” and, therefore, has considered them to be outside the scope of the GST. On this basis, such payments have not been reported in the Department’s BAS.

3.60 Our examination of payments made by the Department to the various educational institutions and providers identified a variety of funding arrangements treated as appropriations, including casual relief teacher grants, quarterly grant payments, emergency relief teacher payments, library resource grants, science in schools grants and sports equipment grants. Given the limited level of documentation available in the Department, further guidance is required to ensure that the treatment of these amounts as appropriations, instead of grants attracting GST, is appropriate. Subsequent to our review, the Department has appointed external consultants to review the current treatment of grants and appropriations.

Need for documentation of GST bad debt policies

3.61 GST legislation provides for the recovery of GST remitted on sales or supplies where an associated debt has been outstanding for over 12 months, or is subsequently written-off.

3.62 In certain entities, GST policies had not been developed or communicated to staff for the correct treatment of bad debts for GST purposes. While recognising that a low level of bad debts generally occurs within government departments, in the absence of adequate policies a risk exists that departments will not recover GST previously paid in relation to long outstanding or bad debts.

3.63 All departments should ensure that GST policies and procedures are updated to incorporate reference to the treatment of bad debts and action be undertaken to ensure that all relevant staff are made aware of the appropriate GST treatment.

Need for updated and ongoing staff training

3.64 Since inception, the GST legislation and the ATO’s GST rulings and interpretive decisions have been regularly amended. For departments to correctly account for GST it is imperative that up-to-date knowledge is maintained concerning these amendments.

3.65 During the review and through discussions with key departmental staff, we noted that while significant attention was directed to training in the GST implementation phase, not all entities have continued regular training sessions for finance and other appropriate staff on the latest GST developments.

3.66 Action should be taken by all departments to implement a program of GST training to key staff on a regular basis. Consideration could also be given to the introduction of a process of regular spot checks to ensure GST transactions have been processed correctly and in line with recent developments. Such a process would also assist in identifying any specific training needs of relevant staff.

Late attribution of GST transactions

3.67 During the course of our examination of GST transactions, the “invoice dates” recorded for all the transactions in accounts payable systems were compared with the dates contained on hard copy invoices/documentation. The comparison revealed that, in certain departments, dates recorded for a substantial number of invoices by the accounts payable system were a month later than the month in which the invoice had actually been received. As a result, these departments were not claiming input tax credits for these invoices until the month after their entitlement to these credits had arisen and, accordingly, were potentially denying themselves of cash flow advantages available from the timely claiming of these credits.

3.68 Although the amounts involved were relatively small, action should be taken by all agencies to ensure the accurate recording of invoices and the timely recovery of input tax credits.

Lack of agreements for Recipient Created Tax Invoices

3.69 Recipient Created Tax Invoices (RCTI) relate to the circumstance where the department receiving goods or services from a supplier, creates an associated invoice for its records and does not actually receive a tax invoice from the supplier concerned. Use of this process may be appropriate for certain e-commerce transactions or where regular and consistent transactions are entered into with a supplier. The use of RCTIs must be supported by an agreement with the supplier and adequate supporting documentation if input tax credits associated with these transactions are to be validly claimed.

3.70 Our review of RCTIs identified that:

- in one department, agreements for the issuing of RCTIs had not been initiated or formalised;
- in another department, an insufficient audit trail existed to support these transactions as, while invoices generated by the department could be located, associated agreements could not be readily provided for review; and
- in another department, the RCTI agreements could be located, however, certain of the invoices generated by the department could not be located for review.

3.71 In the absence of agreements with suppliers and appropriate audit trails to support transactions, departments may be invalidly claiming input tax credits. Accordingly, all departments should ensure that:

- all RCTI arrangements are supported by formal agreements with relevant suppliers;
- a register of all agreements be maintained; and
- steps be taken to ensure that all invoices associated with these arrangements are generated and retained.

Claiming input tax credits on invalid tax invoice documentation

3.72 Under GST requirements, input tax credits may only be claimed where a valid tax invoice is held by an agency.

3.73 A number of instances were observed where non-compliant tax invoices had been processed by certain departments and associated input tax credits incorrectly claimed.

3.74 While the instances identified were relatively few in nature, ongoing training should be provided to staff in the departments concerned to reiterate the requirements for valid tax invoices. A program of regular spot checks of relevant transactions may also assist in ensuring ongoing compliance by staff with policies and procedures for the processing of tax invoices.

Incorrect calculation of GST paid on certain invoices received

3.75 Two departments acquire certain supplies from a supplier via an electronic interface. The departments raise purchase orders by reference to a stock catalogue and record the amount on the purchase order as the invoiced amount in the accounts payable systems. Despite reconciliation processes, the amounts posted to the accounting system do not always agree with the amounts on tax invoices subsequently provided by the supplier. As a result, the potential exists for the departments to either over, or under, claim tax credits.

3.76 Reconciliation processes should be strengthened to identify any discrepancies between prices as noted on the purchase orders and those ultimately charged on the tax invoices.

3.77 The departments concerned have advised that reconciliation processes will be reviewed and, subject to the magnitude of the issue, will be altered to provide a greater level of confidence in the accurate matching of pricing.

Issuing of invalid tax invoices

3.78 Invoices are sometimes manually generated by other areas within departments. This has been identified by the finance division in one agency as a risk with respect to the accounts receivable function, in that such invoices may not be GST compliant.

3.79 We recommended the implementation of training programs targeted at ensuring that staff do not generate invalid tax invoices, the introduction of a tax invoice template and the consideration of centralising invoice generation to the finance division.

Appendixes

Payroll management

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APPENDIX 2A

Payroll management

CHARACTERISTICS OF AGENCIES

The following table outlines characteristics of agencies included in the review, which impact on their administration of the payroll function.

CHARACTERISTICS OF AGENCIES INCLUDED IN THE REVIEW

<i>Agency</i>	<i>Employee-related expenditure</i>	<i>Approximate number of employees</i>	<i>Other characteristics</i>
	(\$m)	(no.)	
Parliament of Victoria	47	650	<ul style="list-style-type: none"> • Payroll incorporates parliamentarians, electoral office staff and staff located at Parliament House. • Payroll centralised, but relies on input from electoral offices. • Virtually all payroll processes undertaken internally.
Department of Treasury and Finance	66	600	<ul style="list-style-type: none"> • Majority of staff within public service, but also pays ministerial staff. • Virtually all aspects of payroll and human resource are outsourced.
Department of Premier and Cabinet	41	480	<ul style="list-style-type: none"> • Majority of staff within public service. • Virtually all aspects of payroll and human resource are outsourced.
Department of Education and Training	3 057	55 000	<ul style="list-style-type: none"> • Responsible for payment of teaching and majority of other staff located in State primary and secondary schools. • Centralised system but approval and processing may rest with schools. • All payroll functions are undertaken internally.
Department of Human Services	603	11 900	<ul style="list-style-type: none"> • Central oversight of payroll functions. • Processing and approval decentralised to regions. • Outsourcing used for final stages of processing and production of payroll documentation. • Staff employed under a number of awards.
Department of Justice	260	4 300	<ul style="list-style-type: none"> • Includes payroll function of judiciary and court system. • Staff mainly employed under Victoria public service conditions. • Decentralisation of certain processes to business units. • Outsourcing only used for final stages of processing and production of payroll documentation.

CHARACTERISTICS OF AGENCIES INCLUDED IN THE REVIEW - *continued*

<i>Agency</i>	<i>Employee-related expenditure</i>	<i>Approximate number of employees</i>	<i>Other characteristics</i>
	<i>(\$m)</i>	<i>(no.)</i>	
Department of Natural Resources and Environment	292	4 800	<ul style="list-style-type: none"> Decentralised approval and processing of data input by regional centres. Final processing and reporting performed under outsourcing arrangements.
Department of Infrastructure	58	820	<ul style="list-style-type: none"> Virtually all staff classified as within the public service. Centralised payroll administration performed largely by internal resources.
Department of Innovation, Industry and Regional Development	60	670	<ul style="list-style-type: none"> Virtually all staff classified as within the public service. Centralised payroll administration performed largely by internal resources.
Department of Tourism, Sport and the Commonwealth Games	4	220	<ul style="list-style-type: none"> Virtually all staff classified as within the public service. Centralised payroll administration performed largely by internal resources.
Office of the Chief Commissioner of Police	818	12 100	<ul style="list-style-type: none"> Includes 11 500 sworn members in the police force. Many payroll functions decentralised to 5 regions with head office maintaining responsibility for oversight of system and final processing. Virtually all functions undertaken using internal resources.
State Revenue Office	24	440	<ul style="list-style-type: none"> Virtually all employees within the Victorian public service. Payroll administered internally with system and training support from external provider.
Banyule City Council	24	930	<ul style="list-style-type: none"> Range of awards and agreements covering local government staff. Centralised and internal payroll processing and management.
Bayside City Council	15	414	<ul style="list-style-type: none"> Range of awards and agreements covering local government staff. Substantial aspects of payroll administration are outsourced.
Women's and Children's Health Service	244	5 000	<ul style="list-style-type: none"> Employees within Victorian Health Industry Association that has in place 32 separate awards. Production of payslips and group certificates outsourced.
Victorian Legal Aid Commission	18	400	<ul style="list-style-type: none"> Most staff covered under a single enterprise agreement. Payroll administered in-house with the exception of salary packaging.
Melbourne Exhibition and Convention Centre Trust	14	570	<ul style="list-style-type: none"> Single enterprise agreement for the majority of staff. Centralised and in-house payroll processing with system support from external provider.

APPENDIX 2B

Payroll management

POLICIES AND PROCEDURES REQUIRING CONSIDERATION IN A PAYROLL FUNCTION

The following table outlines key areas associated with the payroll function.

<i>Potential policy/procedural area</i>	
<ul style="list-style-type: none"> • Overview of requirements of relevant legislation and regulations. • Schedule of delegations for payroll and human resource approval processes. • Roles and responsibilities of: <ul style="list-style-type: none"> • payroll staff; • human resources staff; • other employees with involvement in the payroll and human resources function; and • external contractors when operating in an outsourced environment. • Time management and recording. • Human resource policies. • Standard payroll processing forms. • Segregation of duties. • IT system procedures. • Security of data and records. • Use of email to approve/process payroll transactions. 	<ul style="list-style-type: none"> • Overview of requirements of relevant employee agreements. • Procedural guidelines on: <ul style="list-style-type: none"> • appointments; • promotions; • changes to personal details; • variations; • resignations; • redundancies; • long service leave; • annual leave; • superannuation; • allowances and deductions; • bonus payments; and • recovery of overpayments. • Training of HR and payroll staff. • Changes to payroll systems and processes. • Privacy policy.

APPENDIX 2C

Payroll management

POTENTIAL CONTROL PROCEDURES

The following table outlines potential control procedures that could be implemented in a payroll environment.

POTENTIAL CONTROL PROCEDURES

<i>Area of control</i>	<i>Examples of potential control procedures</i>
Management controls	<ul style="list-style-type: none"> • Existence of detailed budgets for payroll expenditure and liabilities. • Regular monitoring of actual expenditure against budget including investigation of variances. • Performance targets are established for payroll and are regularly monitored by senior management. • Relevant business/operational units regularly check accuracy of payroll data. • Appropriate exception reports are produced and acted upon.
File controls	<ul style="list-style-type: none"> • Reconciliations are undertaken between payroll records and the general ledger. • Reconciliations of payroll bank accounts are undertaken and regularly reviewed. • Pay-to-pay or year-to-year reconciliations of payroll totals are undertaken. • Control totals on financial or other data elements are calculated and reconciled.
Control over records	<ul style="list-style-type: none"> • Detailed payroll reports are reviewed and approved by operational unit management. • Error and rejections reports are produced from payroll systems and appropriately followed-up. • Variations to individual payroll records and amounts are independently reviewed and approved.
Input controls	<ul style="list-style-type: none"> • Staff appointments are approved in line with appropriate delegation schedules. • Time records are appropriately reviewed and approved. • All adjustments to pay rates and deductions are appropriately approved and reviewed before input. • Changes to standard data is appropriately reviewed and approved. • Appropriate authorisation and review processes are in place for non-standard payments (e.g. pay in advance, long service leave, lump sum payments, manual cheque payments). • Appropriate reports on changes to payroll data are produced and approved.
Update controls	<ul style="list-style-type: none"> • Procedures are in place to ensure that all transactions have been processed. • Procedures are in place to ensure that correct versions of payroll data files are used (e.g. correct pay rates, tax deduction tables). • Reports of changes to payroll data are produced and reviewed. • Rejection and error reports are produced, reviewed and acted upon.

POTENTIAL CONTROL PROCEDURES - continued

<i>Area of control</i>	<i>Examples of potential control procedures</i>
Segregation of duties	<ul style="list-style-type: none">• The functions of payroll staff are clearly segregated from approval, authorisation and payment functions.• Regular rotation of duties occurs for the payroll function.
Access and security controls	<ul style="list-style-type: none">• Appropriate physical security is maintained over payroll and personnel records and reports.• Appropriate access controls are in place for payroll systems (e.g. password security, regular changes to passwords, levels of access by payroll and other employees).• Reports of access to systems are produced and reviewed for unusual/unauthorised access.

APPENDIX 3A

Administration of the goods and services tax

SAMPLING METHODOLOGY

Attribute sampling methodology was used to select a sample of transactions for testing compliance controls in each department and agency.

Having adopted an upper error limit of one per cent, a confidence level of 80 per cent and a negligible expected error rate, a sample size of 160 transactions was determined for testing.

Based on statistical sampling techniques, we were able to make predictions on the attributes within the total population of transactions, within certain levels of confidence.

The following table outlines what possible test results would mean once actual errors were discovered; that is, that the initial assumption of negligible expected error rate within departments was found during audit testing to be incorrect.

The table examines possible test results and what they mean against 3 different confidence levels, on a 2-sided confidence interval basis.

STATISTICAL DATA FOR EVALUATING TEST RESULTS

Error rate round in sample (%)	Confidence levels and intervals		
	80 per cent	90 per cent	95 per cent
50	44.9-55.1	43.5-56.5	42.3-57.7
40	35.0-45.0	33.6-46.4	32.4-47.6
30	25.4-34.6	24.1-35.9	22.9-37.1
27	22.5-31.5	21.2-32.8	20.1-33.9
25	20.6-29.4	19.4-30.6	18.3-31.7
20	16.0-24.0	14.8-25.2	13.8-26.2
18	14.1-21.9	13.0-23.0	12.1-23.9
16	12.3-19.7	11.2-20.8	10.3-21.7
14	10.5-17.5	9.5-18.5	8.6-19.4
13	10.6-13.1	9.4-13.8	8.1-12.5
12	8.7-15.3	7.8-16.2	7.0-17.0
10	7.0-13.0	6.1-13.9	5.4-14.6
9	6.1-11.9	5.3-12.7	4.6-13.4
8	5.3-10.7	4.5-11.5	3.8-12.2
7	4.4-9.6	3.7-10.3	3.1-10.9
6	3.6-8.4	2.9-9.1	2.3-9.7
5	2.8-7.2	2.2-7.8	1.6-8.4
4	2.0-6.0	1.4-6.6	0.9-7.1
3	1.3-4.7	0.8-5.2	0.3-5.7
2	0.6-3.4	0.2-3.8	0-4.2
1	0-2.0	0-2.3	0-2.5

Using the data in the table, an error rate of 25 per cent in a sample of 160 transactions, it could be concluded with 80 per cent confidence that there was an error rate of between 20.6 and 29.4 per cent in the total population of transactions.

APPENDIX 3B

Administration of the goods and services tax

BETTER PRACTICES EMPLOYED FOR GST ADMINISTRATION

As referred to earlier in this report, a range of processes were considered to represent better practices for the administration of GST. Ensuring that similar practices are implemented across all agencies may be beneficial in improving the quality of GST administration throughout the Victorian public sector. Details of better practices identified are outlined in the following table.

SOUND AND BETTER PRACTICES EMPLOYED FOR GST ADMINISTRATION

<i>Control framework component</i>	<i>Better practices identified</i>
<p>Risk assessment</p> <p>Management should effectively use risk assessment techniques to identify, assess and manage GST risks.</p>	<p>All entities reviewed had procedures in place to manage GST risks involved in the preparation of the BAS.</p> <p>Our review of the procedures for the preparation of the BAS noted the existence of certain control activities undertaken to mitigate risks, prevent irregularities and ensure the integrity of data. These procedures included the performance of reasonableness calculations to ensure the information being lodged with the ATO was accurate.</p> <p>All entities reviewed had undertaken some form of post-implementation review of the GST.</p> <p>During the GST implementation period; a transaction analysis was undertaken by all departments in order to identify and correctly classify each class of transaction made. This detailed level of analysis assisted in clearly identifying, assessing and managing areas of risk in the agency.</p>

<i>Control framework component</i>		<i>Sound and better practice</i>
Control environment Management should establish specific controls for the BAS processes and the GST requirements of the expenditure and revenue cycles. These activities should mitigate risks, prevent and detect irregularities, safeguard assets and ensure completeness and accuracy of data.		In one of the entities reviewed, a BAS mismatch report is run several times until all transactions are error free to ensure that there is no miscoding of GST transactions. This is a very strong control measure when used with the BAS summary report (the electronic version of a draft BAS to be lodged with the ATO).
Structure	Responsibility for managing and processing the GST is structured in a way that efficiently meets the needs of the organisation and allows for clear responsibilities and accountabilities.	In all entities reviewed, the Accounts Payable (AP), Accounts Receivable (AR) and BAS preparation duties are undertaken by different staff members. This separation of duties is supported by the level of Oracle (accounting software) access granted to AP staff can only access AP information on the Oracle system. Generally BAS reports are generated from the Oracle system, and compared with general ledger reports. Differences are investigated and corrections are made. Generally, the BAS is reviewed and signed-off by a staff member other than the person responsible for preparation. Checklists for ATO settlement procedures also exist in some entities.
Process	There are complete policies and procedures that reflect the organisation's responsibilities.	All entities reviewed have in place policies and procedures that reflect the agency's responsibilities and support GST compliance. The extent to which these were documented varied across the entities reviewed, as did the extent to which entities had introduced processes aimed at ensuring such policies and procedures are regularly reviewed and updated.
People	Key personnel possess an appropriate level of competence and are aware of their responsibilities through training and communication.	All entities reviewed provided extensive GST training programs for key staff as part of the GST Implementation process. Most entities referred to the Knowledge Data base for GST established by the Department of Treasury and Finance as a key source for maintaining or updating staff knowledge. Key personnel interviewed in all departments have an appropriate level of competence in relation to the GST.
Technology	Information system design and functionality effectively and efficiently support GST processing and obligations.	All entities reviewed utilise the Oracle accounting system. This system is automated, with some entities making manual adjustments for journal entries (i.e. accruals). The system is tax code driven, and comprehensive reports (by tax code) can be obtained to check BAS figures. As the system is tax driven, only a defined list of tax codes may be used. Detailed reconciliations are performed between the calculated BAS figures and the figures contained in the general ledger. In most entities, exception reports are also generated and reviewed. Generally, the ability to trace GST transactions through systems and processes was found to be highly advanced and user friendly.

<i>Control framework component</i>		<i>Sound and better practice</i>
Control activities Management should have established specific control activities relating to BAS processes and the GST requirements of the expenditure and revenue cycles. These activities mitigate risks, prevent and detect irregularities, safeguard assets, and ensure completeness and accuracy of data.		
Management controls	Management implement detective controls through supervision and review.	In most entities, the Accounting Manager (or equivalent) reviews the BAS information and undertakes some high-level test-checking prior to signing-off the monthly BAS and proceeding with lodgement of the BAS with ATO. Separation of duties and delegations provides a strong safeguard to the administration and control of GST processing.
Organisational controls	The GST function is effectively organised to ensure registration compliance, maintenance of documentation and segregation of duties.	In all entities reviewed, some form of "purchase order" form is completed for each transaction, which includes identification of tax coding for GST purposes and withholding details for vendors. Generally, prior to processing the invoice, staff will ensure that tax invoices match requisition details and that invalid tax invoices are sent back to a supplier for resubmission in a valid form. In certain entities, checklists exist to assist processing staff and ad hoc reviews are undertaken in order to ensure that staff are correctly processing documentation.
Authorisation controls	GST-related transactions are appropriately authorised.	Numerous controls existed in the entities reviewed to ensure that GST-related transactions were appropriately authorised, including: <ul style="list-style-type: none"> • controlled processing and approval of transactions by accounts payable staff, who complete a coversheet for each transaction; • investigation of any material discrepancies and rectification of errors before final sign-off of the BAS; • generally, the authority to change BAS codes is restricted to certain finance staff; and • unusual purchases are reviewed prior to being processed by the Finance Team.
Operational controls	There are effective preventative and detective controls that ensure the completeness, accuracy and timeliness of GST transactions.	In all entities reviewed, preventative controls were in place to ensure the integrity of the information entered on the system – generally when an invoice is received, an accounts payable officer reviews the invoice for GST compliance, and ensures certain criteria are checked prior to processing through the system and assigning a tax code (e.g. tax invoice requirements; whether GST has been correctly charged). Detailed processes also exist to guide procedures to be followed where tax invoices do not meet the usual parameters.

<i>Control framework component</i>		<i>Sound and better practice</i>
Control activities - continued		
Computing controls	<p>There are effective and complete system controls that protect the integrity of GST data because:</p> <ul style="list-style-type: none"> • system master file controls protect the integrity of GST data; and • systems and data are subject to physical and logical controls. 	<p>In all departments reviewed, GST is calculated by the system according to defined GST codes. Changes to coding in the Oracle system can only be undertaken by the Information Technology (IT) division.</p> <p>Generally, IT requires sign-off from Finance prior to any amendments made to tax codes. This ensures that appropriate authorisation is sought prior to altering the tax status of an item.</p> <p>In one department, the system has been enhanced so that it triggers emails to employees who have posted to certain accounts, e.g. FBT declarations and other tax reminders. This ensures that declaration are signed and maintained, and that reversing entries or reallocations are processed appropriately.</p>

<i>Control framework component</i>		<i>Sound and better practice</i>
Information and communication		
<p>The right information about the GST and its impacts is communicated to the right people at the right time.</p>		<p>In all departments reviewed, finance staff received comprehensive GST training during the GST implementation process.</p> <p>The Managers of Taxation and Accounting Operations/Finance Managers generally forward all relevant GST updates/changes to staff. Such changes are generally either identified as a result of regular updates received from external service providers or from DTF. In some departments, internal advice/circulars and bulletins concerning the GST have been consolidated and are contained on the entities' intranet.</p> <p>Departments are aware of their ability to email their queries to DTF, which provide a response in due course. These queries are answered through DTF's current GST advisors.</p>

<i>Control framework component</i>		<i>Sound and better practice</i>
Monitoring and review		
<p>There is evidence of a continuous improvement approach to GST processing by the organisation making effective use of in-built and/or periodic monitoring and review mechanisms.</p>		<p>Monthly meetings are held with DTF in which departmental personnel are advised of any new GST developments. New GST rulings are sent to key personnel via email.</p> <p>One of the departments reviewed introduced a Tax Committee in mid-2001. The Tax Committee meets fortnightly to review and discuss various tax issues, ensuring that the agency is committed to continuous improvement in relation to the GST and wider tax reform.</p> <p>Some of the departments reviewed utilise the PAYG offset facility as a means of maximising cash flow from the GST.</p> <p>All departments have introduced processes to ensure compliance with the Victorian Government's Taxation Compliance Framework.</p>



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