

The Auditor-General
Audit Report No.3 2004-05
Business Support Process Audit

Management of Internal Audit in Commonwealth Organisations

Australian National Audit Office

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of Australia 2004

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Canberra ACT
23 July 2004

Dear Mr President
Dear Mr Speaker

The Australian National Audit Office has undertaken a business support process audit across agencies in accordance with the authority contained in the *Auditor-General Act 1997*. Pursuant to Senate Standing Order 166 relating to the presentation of documents when the Senate is not sitting, I present the report of this audit and the accompanying brochure. The report is titled *Management of Internal Audit in Commonwealth Organisations*.

Following its presentation and receipt, the report will be placed on the Australian National Audit Office's Homepage—<http://www.anao.gov.au>.

Yours sincerely

A handwritten signature in black ink, appearing to read 'P. J. Barrett'.

P. J. Barrett
Auditor-General

The Honourable the President of the Senate
The Honourable the Speaker of the House of Representatives
Parliament House
Canberra ACT

AUDITING FOR AUSTRALIA

The Auditor-General is head of the Australian National Audit Office. The ANAO assists the Auditor-General to carry out his duties under the *Auditor-General Act 1997* to undertake performance audits and financial statement audits of Commonwealth public sector bodies and to provide independent reports and advice for the Parliament, the Government and the community. The aim is to improve Commonwealth public sector administration and accountability.

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Abbreviations

AASB	Australian Accounting Standards Board
AWP	Audit Work Program / Plan
ANAO	Australian National Audit Office
APS	Australian Public Service
CAC	Commonwealth Authorities and Companies
CEI	Chief Executive's Instructions
CEO	Chief Executive Officer
CFO	Chief Financial Officer
CIA	Chief Internal Auditor
CPA	Certified Practising Accountants
FMA	Financial Management and Accountability
ICAA	Institute of Chartered Accountants in Australia
IIA	Institute of Internal Auditors
ISACA	Information Systems Audit and Control Association
JCPAA	Joint Committee of Public Accounts and Audit
PAS	Performance Assessment Scheme
RMP	Risk Management Plan
SES	Senior Executive Officer

Summary and Recommendations

Summary

Internal audit

1. Internal audit is a key component of any organisation's governance framework, and plays a critical role in providing assurance regarding the conformance and performance of the organisation's systems and administrative processes.
2. It is generally recognised as better practice¹ to have a competent and adequately resourced internal audit group to support the statutory role² of the audit committee within Commonwealth organisations.
3. The role of internal audit has evolved from that of an assessor of compliance with procedures and controls, to a strategic partner with the organisation's executive management. Internal auditors can expect to be responsible for many, broad and varied tasks, ranging from assessing the quality, economy and efficiency of business activities and controls, to advising on opportunities to harness emerging technologies and improved business practices, including advice on the design and application of risk management practices. They may also be expected to play a key role in promoting, educating and coaching the organisation's staff in key principles, procedures and controls.
4. Internal audit typically operates as a discrete organisational unit. It should have no direct involvement in day-to-day operations or decision-making. This structure helps to create a degree of independence from the processes and systems, which the group exists to appraise.

Audit objective

5. The objective of the audit was to assess whether selected Commonwealth organisations had utilised better practice principles when establishing the role, and managing the use, of their internal audit groups.
6. In order to evaluate internal audit, the Australian National Audit Office (ANAO) first considered the status and accountabilities of internal audit within the overall governance framework of the organisations audited, in particular its accountabilities to the audit committee.

¹ ANAO Better Practice Guide, *New Directions For Internal Audit—A Guide for Public Sector Managers*, Canberra, July 1998 [*The Internal Audit Guide*]. Available: <www.anao.gov.au>.

² Refer *Financial Management and Accountability Act 1997* (FMA Act), section 46, and *Commonwealth Authorities and Companies Act 1997* (CAC Act), sections 32 and 44.

Audit conclusion

7. The ANAO concluded that each of the audited³ Commonwealth organisations had established an internal audit group, with responsibilities and accountabilities that were largely consistent with better practice guidance and professional requirements, as well as the legislative requirements of Commonwealth audit committees.⁴

8. In considering the status and accountabilities of internal audit within the audited organisations' governance frameworks, the ANAO found that the internal audit group was accountable to both the audit committee and Chief Executive Officer (CEO).

9. Given the direct accountability of the internal audit group to the audit committee, the ANAO examined the independence of the audit committee. The ANAO found that the audited organisations had appointed senior managers, with functional responsibilities across the organisation, and an external 'independent' representative to their audit committees. The ANAO concluded that the most appropriate membership of the audit committee, at any point in time, may need to be reviewed by the CEO. This should take into account the coverage of the proposed program of internal audits and the functional responsibilities of the committee members, as well as observed better practice.

10. The ANAO found that internal audit charters adequately articulated the role of internal audit, and were supplemented by business plans and other procedural documents. The responsibilities of the internal audit groups were primarily achieved through the development, approval and delivery of risk-based audit work programs. The programs of audits were developed by the internal audit groups, in consultation with key stakeholders, using structured planning approaches. The programs focussed on providing assurance on both the conformance and performance of the organisations' critical business systems and processes over one to three years. However, the documentation supporting the development, approval and periodic review of the audit work programs was not always adequate to support the transparency and objectivity of these processes.

11. Internal audit also had a critical role in reporting to audit committees on the implementation of outstanding internal and external audit recommendations. The ANAO found that all audited organisations were working to improve the quality and timeliness of this reporting, and that this

³ A list of the Commonwealth organisations audited as part of this audit is provided in the Audit Scope (paragraph 1.12) in Chapter 1.

⁴ The better practice guidance and professional requirements for internal audit, and the legislative requirements of audit committees in Commonwealth organisations, are discussed in Chapter 1.

would assist them in improving the timeliness of the implementation of outstanding audit recommendations.

12. The ANAO found that the internal audit groups had adequate resources to complete the tasks approved in audit work programs. All audited organisations used out-sourced internal audit service providers, to provide flexibility and capability in delivering the program of work within the timeframe required. In addition, all audit staff were guided by relevant legislation and professional standards. As well, all internal audit groups demonstrated the Chief Internal Auditor's involvement in ongoing supervision and review of the quality and completeness of work. However, poor record-keeping practices had led to some inconsistent or inadequate documentation.

13. The ANAO also found that, in accordance with better practice principles, internal audit were subject to ongoing oversight and periodic review by the audit committees. However, only two of the audited organisations could demonstrate their formal evaluation of the internal audit groups against agreed performance measures. In addition, professional guidance requires internal audit to complete periodic external (independent) evaluations of their operations. At the time of audit fieldwork, none of the audited organisations had stated such a requirement for their internal audit groups. The ANAO considered that performance measures could be more comprehensively documented and applied, to enable the objective evaluation of the value, timeliness and quality of internal audit products and services.

14. The ANAO considers that, in line with heightened expectations and requirements relating to governance, risk management and audit assurance, there is a need for priority to be given to the improvement of the management and use of internal audit by Commonwealth organisations. The ANAO has made eight recommendations for the improvement of internal audit, which may be relevant to all Commonwealth organisations.

Recommendations

The following recommendations are based on the findings from the organisations audited but are likely to have relevance to other Commonwealth organisations. The recommendations are based on published better practice principles and professional guidance,⁵ and take into account developments that have the potential to impact on the role and operation of internal audit. It is recognised that some Australian Public Service (APS) organisations will have already implemented some of these recommendations.

Recommendation No.1
Paragraph 2.17

The ANAO recommends that Commonwealth organisations clearly document the roles, responsibilities and accountabilities for all of their governance committees.

Recommendation No.2
Paragraph 2.33

The ANAO recommends that, in order to facilitate the objective assessment of the proposed internal audit work program (AWP), internal audit groups provide audit committees with documentation supporting the:

- comparative assessments of risks, and proposed internal audit topics, including definitions for terms used and ratings applied; and
- description of each proposed audit, and an estimation of the timeframe and resource requirements to complete each audit.

Recommendation No.3

The ANAO recommends that audit committees clearly document within the minutes of their meetings the:

- Paragraph 2.40**
- rationale for selecting the approved list of approved internal audit topics;
 - approved internal AWP, with evidence of links between the organisation's assessed and prioritised risks and the internal audit topics; and
 - nature and outcome of discussions relating to the periodic review of the internal AWP.

⁵ Relevant better practice guidance and professional requirements are discussed in Chapter 1.

- Recommendation No.4**
Paragraph 2.55
- The ANAO recommends that, in order to facilitate the timely resolution of longer-term outstanding recommendations from audit reports, audit committees prioritise outstanding recommendations, and monitor implementation strategies and progress, commensurate with current assigned priorities.
- Recommendation No.5**
Paragraph 3.25
- The ANAO recommends that internal audit groups review the completeness and currency of their charters, to establish guidance on, and mechanisms for, the effective and efficient operation of the internal audit group within the broader governance framework.
- Recommendation No.6**
Paragraph 5.31
- The ANAO recommends that, in accordance with good record-keeping practices, internal audit groups maintain adequate documentation to support the transparency and objectivity of decisions made in relation to the development of the AWP, as well as resource management for the internal audit group.
- Recommendation No.7**
Paragraph 5.52
- The ANAO recommends that internal audit groups of Commonwealth organisations provide complete and current practice management and professional guidance to their in-house internal audit staff. Guidance material should also clarify requirements for conducting internal and external quality assurance reviews.
- Recommendation No.8**
Paragraph 6.14
- The ANAO recommends that internal audit groups establish, document and use performance measures, which would facilitate the objective and transparent evaluation of the group and its audit products. Performance measures should be periodically reviewed to confirm their ability to provide useful information on audit resource management, relationship management, product and process quality, and product impact.

15. Each of the audited organisations agreed with the recommendations. Organisations' responses to the recommendations are provided following each recommendation in the main body of the Report. General comments provided by the audited organisations have been included in Appendix 1.

Audit Findings and Conclusions

1. Introduction

This Chapter defines internal audit and establishes its place within the governance framework. It also explains the legislative and professional frameworks within which it exists. The Chapter concludes with a discussion of some of the emerging challenges facing internal audit.

Introduction

1.1 The Chief Executive Officers (CEOs) of Commonwealth organisations are required under the *Financial Management and Accountability Act 1997* (FMA Act) and the *Commonwealth Authorities and Companies Act 1997* (CAC Act) to manage the affairs of their entities in a manner that promotes effective, efficient and ethical use of Commonwealth resources.⁶ This necessitates the development and implementation of effective governance arrangements, which encompass such elements as risk management and business planning, accountability and conformance mechanisms, and performance monitoring and review.

1.2 In particular, the FMA and CAC Acts identify the audit committee, which exists to assess aspects of organisation conformance and performance, as a key component of the governance arrangements. The audit committee is typically supported by an internal audit group. Internal audit can broadly be described as an appraisal activity, established as a tool of the executive management. The Institute of Internal Auditors (IIA) defines internal audit as being:

A department, division, team of consultants, or other practitioner(s) that provides independent, objective assurance and consulting services designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.⁷

1.3 The role of internal audit has evolved from that of an assessor of compliance with procedures and controls, to a strategic partner with the organisation's executive management. Internal auditors can expect to be responsible for many, broad and varied tasks, ranging from assessing the quality, economy and efficiency of business activities and controls, to advising on opportunities to harness emerging technologies and improved business

⁶ Refer FMA Act, section 44, and CAC Act, section 22.

⁷ IIA, *International Standards for the Professional Practice of Internal Auditing*, Florida, January 2004 [IIA Standards]. Available: <www.theiia.org>.

practices,⁸ including advice on the design and application of risk management practices. They may also be expected to play a key role in promoting, educating and coaching the organisation's staff in key principles, procedures and controls relating to both financial performance and assurance, as well as to organisational performance.

1.4 Internal audit typically operates as a discrete unit, with no direct involvement in the organisation's day-to-day operations. This structure helps to create a degree of independence from the systems and processes, which it exists to appraise. While internal audit should contribute to better decision-making, it should not be involved in the management functions.

1.5 Each year, internal audit should review its strategic audit plan to develop a risk-based annual program of activities and services, in consultation with its key stakeholders. The program will list potential audit topics, and provide descriptions of the scope, objectives, timing and resourcing⁹ for each task. The audit committee, and CEO, should review and approve the program.

1.6 Internal audit will then periodically report to these stakeholders on its progress towards completing its program of activities. As part of this, internal audit will report on areas where there are inadequate or ineffective controls, and make recommendations for their improvement. The audit committee in providing assurance, and making recommendations, to executive management, will use this information as part of its assessment.

Audit objectives and scope

Audit objective

1.7 The objective of this audit was to assess whether selected Commonwealth organisations had utilised better practice principles when establishing the role, and managing the use, of their internal audit groups.

1.8 In order to evaluate internal audit, the Australian National Audit Office (ANAO) first considered the status and accountabilities of internal audit within the overall governance framework of the organisations audited, in particular its accountabilities to the audit committee.

⁸ This generally also includes assessments regarding the:

- organisation's compliance with legislation, policies and procedures;
- design of procedures and systems for control;
- efficiency and effectiveness of business processes and activities; and
- financial regularity.

⁹ Broadly, resourcing for audit tasks includes funding and staffing considerations.

Previous reviews by the ANAO involving internal audit

1.9 This audit follows-on from a number of previous audits and studies of internal audit by the ANAO. The most recent audit was completed in 1997–1998,¹⁰ and was a precursor to the release of the ANAO's Better Practice Guide on Internal Audit (The Internal Audit Guide), released in 1998.¹¹

1.10 Since the release of the Internal Audit Guide, the ANAO has undertaken a series of benchmarking studies on internal audit, incorporating cost, quality, time and quantity metrics.¹² While these studies provided insights into how internal audit groups within Commonwealth organisations were performing against their international counterparts, the studies did not explore:

- the management of internal audit;
- its ability to satisfy the strategic objectives of the organisation; nor
- its ability to support the corporate governance framework.

1.11 In addition, each year the ANAO prepares a report, which explores the control structures of major Commonwealth organisations. The two most recent reports found that there are opportunities for Commonwealth organisations to strengthen the operation of, and reconsider the focus of roles and activities for, their audit committees and internal audit groups.¹³ While the ANAO observed, in 2002–2003, that good progress had been made by most of the Commonwealth organisations, further progress and refinement was still possible. In particular, organisations should regularly review the adequacy of their governance arrangements, and the efficiency and effectiveness achieved from their internal audit groups.

¹⁰ ANAO Audit Report No.46 1997–1998, *Internal Audit*, Canberra, May 1998. Available: <www.anao.gov.au>.

¹¹ ANAO, *The Internal Audit Guide*, op.cit.

¹² ANAO Audit Report No.14 2000–2001, *Benchmarking the Internal Audit Function*, Canberra, October 2001, and ANAO Audit Report No.13, 2002–2003, *Benchmarking the Internal Audit Function Follow-on Report*, Canberra, October 2002. Available: <www.anao.gov.au>.

¹³ ANAO Audit Report No.67 2001–2002, *Control Structures as part of Financial Statements of Major Commonwealth Entities for the Year Ending 30 June 2002*, Canberra, pp.14, 15 and 31–34, and ANAO Audit Report No.61 2002–2003, *Control Structures as part of Financial Statements of Major Commonwealth Entities for the Year Ending 30 June 2003*, Canberra, p.15. Available: <www.anao.gov.au>.

Audit scope

1.12 The ANAO audited four Commonwealth organisations:

- Department of Health and Ageing;
- Department of Employment and Workplace Relations;
- Comcare Australia; and
- IP Australia.

1.13 The scope of this audit precluded a thorough examination of the governance arrangements within the Commonwealth organisations audited. However, the governance frameworks, and, in particular, audit committees, were examined to determine their influence on the role and operation of the internal audit groups. The ANAO used this intelligence to make an assessment of the organisations' performance against established better practice principles.

1.14 Specifically, this audit examined the:

- roles and responsibilities of internal audit groups;
- development, approval and delivery of risk-based audit work programs and/or other services by internal audit groups;
- resource and practice management mechanisms used to facilitate the timely delivery of quality audit products;
- record-keeping and reporting practices that facilitate the timely dissemination of information and attention to issues; and
- performance evaluation of internal audit.

Audit methodology

1.15 The audit methodology involved interviews with selected officers, the examination of documentation and records, and general observation and inspection.

1.16 This Report primarily draws on the principles and guidance established in *The Internal Audit Guide*,¹⁴ and the professional standards of the accounting professions and the IIA. In addition, the ANAO referred to relevant Commonwealth legislation, and other ANAO and private sector better practice guides, relevant to control structures, audit committees and internal audit.

¹⁴ ANAO, *The Internal Audit Guide*, op.cit.

Management reporting

1.17 As part of this audit, the ANAO provided each audited organisation with a management report on their internal audit groups, which included a number of detailed and specific recommendations relevant to the particular organisation.

Better practice guidance and professional standards referred to during this audit

Better practice guidance

1.18 The Internal Audit Guide¹⁵ provides a series of better practice principles, steps and tools to assist organisations when undertaking a systematic approach to establishing and re-evaluating their internal audit groups.

Professional accounting standards

1.19 In Australia, the auditing profession operates under a co-regulatory regime, with the three main accounting bodies (the Institute of Chartered Accountants in Australia [ICAA], the Certified Practising Accountants in Australia [CPA Australia] and the National Institute of Accountants [NIA]) developing rules (standards) and codes of professional conduct for their members. Guidance for member auditors on these concepts is available in the Australian Auditing and Accounting Standards, Guidelines and Codes of Conduct, and relates mainly to external audit. The guidance discusses concepts such as auditor independence, ethical conduct, quality control and communication requirements.

Institute of Internal Auditors

1.20 Internal auditors are generally guided by the professional standards issued by the IIA, entitled *International Standards for the Professional Practice of Internal Auditing* (IIA Standards).¹⁶ The purpose of the standards is to establish principles and practices for internal audit, and a framework within which it can be performed. The IIA Standards also provide a basis for the evaluation of the internal audit group's performance, and promote a culture focussed on

¹⁵ *ibid.*

¹⁶ The internal audit groups in all audited organisations indicated that they recognised and applied the professional standards issued by the IIA. Therefore, the ANAO has referred, where appropriate, to the provisions within the IIA Standards as part of this audit, and within this Report.

improving organisational processes and operations. Broadly, the IIA Standards are structured into attribute, performance and implementation standards. Members of the IIA are also guided by the Professional Practices Framework, which includes a Code of Conduct.

1.21 The IIA Standards were issued in July 2000, and were amended in January 2004. The ANAO understands that the IIA plans to release a best practice guide for internal audit during 2004.

Report structure and audit criteria

1.22 The Report is structured as follows.

- Chapter 2—Governance Frameworks and Internal Audit
- Chapter 3—The Role of Internal Audit
- Chapter 4—Developing the Internal Audit Work Program
- Chapter 5—Delivering the Internal Audit Work Program
- Chapter 6—Evaluating Internal Audit

1.23 Each Chapter of this Report outlines the better practice principles against which the selected Commonwealth organisations were assessed, together with the ANAO's observations and findings.

1.24 This audit was undertaken in conformance with ANAO auditing standards, at an approximate cost of \$300 000.

Challenges for internal audit

1.25 The ANAO recognised that there are a number of ongoing and emerging challenges for the management of internal audit groups that all Commonwealth organisations will need to consider. Some of these are discussed below.

Heightened interest in governance frameworks

1.26 Over the past five years, a series of corporate mishaps and collapses, both in Australia and internationally,¹⁷ have heightened attention on the importance of good governance for investor and consumer confidence. The changing environment has significant consequences for both public and private sector auditors, given the increased emphasis on establishing and demonstrating sound control systems, sound risk management, and on

¹⁷ For example, ENRON, HIH Insurance, Parmalat, and the National Australia Bank.

achieving a suitable balance between conformance and performance requirements. Auditors have also been the focus of considerable scrutiny, with attention particularly being directed at the concept of auditor independence. The profession itself has been concerned to restore public confidence in financial reporting.¹⁸

1.27 Recent reviews¹⁹ have seen developments in requirements for external auditors of publicly listed companies, including:

- improving the independence of the auditor, through:
 - employment relationships;
 - financial relationships; and
 - provision of non-audit services;
- implementing mechanisms designed to enhance audit independence, such as:
 - mandating audit standards (including competency requirements);
 - audit committee having independent (external) members, including chairpersons; and
 - requiring a board to oversee audit independence issues; and
- improving governance arrangements, including:
 - having the CEO and Chief Finance Officer (CFO) sign-off that financial reports comply with legislation and are materially truthful and complete; and
 - the development of governance standards that would be given legislative backing.

1.28 These developments are likely to focus the attention of the senior executive in public sector entities on the independence, competency and effectiveness of their external, and internal, audit services. Audits will only be of value if they are both in fact, as well as perceived to be, independent of an organisation's executive and line management. Demonstrating, and

¹⁸ International Federation of Accountants (IFAC) Task Force on Rebuilding Public Confidence in Financial Reporting (Credibility Task Force), *Rebuilding Public Confidence in Financial Reporting: An International Perspective*, New York, August 2003. Available: <www.ifac.org/credibility>.

¹⁹ For example, those contained within Corporate Law Economic Reform Program (CLERP) 9, the Ramsay Report of 2001 (*Independence of Australian Company Auditors, Report to the Minister for Financial Services and Regulation*, Department of the Treasury) and Report No.391 of the Joint Committee of Public Accounts and Audit, *Review of Independent Auditing by Registered Company Auditors*, September 2002.

maintaining, auditor independence and auditor competence will be key challenges for internal and external auditors.

An effective audit committee (oversight of scope and quality of internal audit work)

1.29 In the private sector, it has been suggested that organisations are not managing their internal audit services in a manner that enables them to adequately monitor the financial and operational implications of their activities.²⁰ Nor are they obtaining this information through other means (for example, consultancies). Poor quality information, including limited audit products, will restrict executive management's ability to make sound strategic and financial decisions, and/or appropriate operational resource allocations.

1.30 Changes in operating arrangements and service delivery methods in the public sector, including government on-line, and multiple agency and/or public/private sector partnerships, are increasing the level of complexity for auditors in reviewing, and gaining assurance over, the total business process. Internal auditors may have to deal with issues surrounding the governance, transparency and openness of these relationships by gaining access to audit evidence held by public or private sector bodies in respect of which they have no specific mandate.

1.31 In addition, the increasing level of complexity brings with it the challenge of appointing a suitably experienced and competent mix of members to the audit committee. Effective audit committees are fundamental to executive management's confidence in organisations' corporate governance, including risk management and internal controls.

1.32 The audit committee must demonstrate its effective operation through due consideration of the audit work program, questioning audit findings, and following through on the implementation of audit recommendations. To perform their role effectively, members must be well supported and kept up to date with changes and developments in the audit profession, business practices and governance domains. The importance of the audit committee's work also needs to be fully appreciated throughout the organisation.

²⁰ Fenton-Jones, Mark, *Internal Auditors Now the Focus*, Australian Financial Review, 23 May 2003.
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2. Governance Frameworks and Internal Audit

Introduction

2.1 The term public sector governance has a very broad coverage. It includes how an organisation is managed, its corporate and other structures, its culture, its policies and strategies, and the way it deals with its various stakeholders. The concept encompasses the manner in which public sector organisations acquit their responsibilities of stewardship by being open, accountable and prudent in decision-making, providing policy advice, and managing and delivering programs.²¹

2.2 Effective public sector governance requires leadership from the executive management of the organisation, and a commitment to integrity, accountability and transparency from all within the organisation. Governance aims to ensure that an organisation achieves its overall outcomes in a manner that enhances confidence in the organisation, its decisions, and its actions.

2.3 Organisations normally have a number of committees within their governance framework. This could include committees to address the governance,²² financial management, ethics and human resource management needs of the organisation. In particular, the CEOs of Commonwealth organisations are required to establish an audit committee as part of their governance arrangements.²³ The audit committee will be responsible for providing assurance on the operation of the control structure, and the veracity of financial reporting.

2.4 In addition to the governance committees, internal audit is increasingly being viewed as a critical component of an effective governance framework. The internal audit group will report to an audit committee and/or the organisation's CEO on control structure and financial assurance matters, and may be involved in efficiency and effectiveness reviews of corporate, business or program delivery areas.

²¹ ANAO Better Practice Guide, *Public Sector Governance*, Canberra, July 2003, [*The Governance Guide*], Volume 1, *Framework, Processes and Practices*, p.6. Available: <www.anao.gov.au>.

²² Including the executive or management board, risk management committee, and audit committee.

²³ Refer to section 46 of the FMA Act, and sections 32 and 44 of the CAC Act.

Overview of governance frameworks in audited organisations

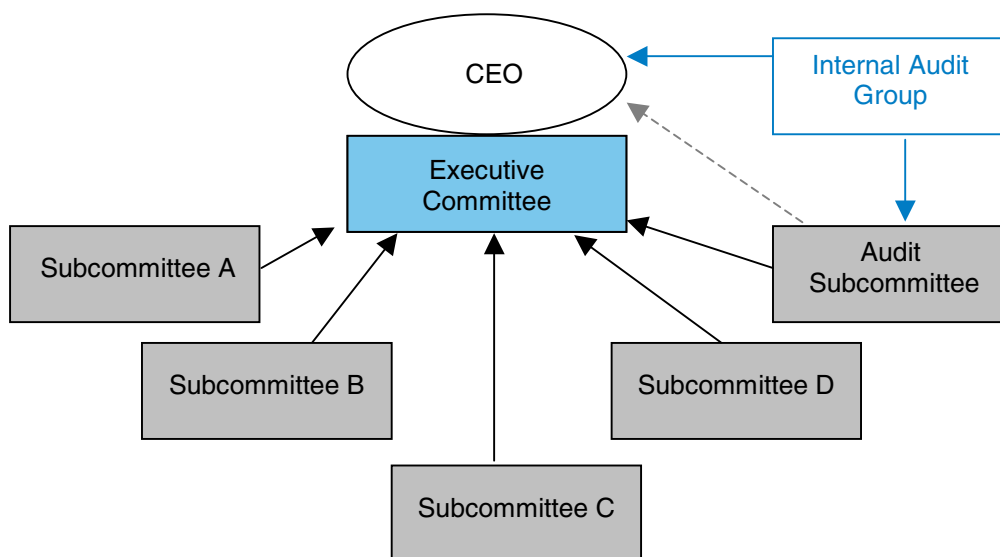
2.5 For the purpose of this audit, the ANAO initially obtained a broad understanding of the governance frameworks in the organisations audited, to determine which committees were relevant to the consideration of the operation and management of internal audit.

2.6 The ANAO found that all audited organisations had established a governance framework to support the achievement of organisational outcomes, and promote the desired culture.²⁴ Three of the four audited organisations had documented an overview of their current governance arrangements, and the other was in the process of doing so at the time of audit fieldwork. Governance arrangements and responsibilities were published on organisations' intranets, so that all staff had access to the information.

2.7 An overview of the typical governance structure, and relationships, observed by the ANAO during the audit is depicted in Figure 2.1.

Figure 2.1

Overview of the Governance Framework



Source: Prepared by the ANAO based on information in the audited organisations' governance policies.

²⁴ Including elements such as high standards of professional and ethical conduct, prudent management of risk, financial accountability, a commitment to developing and harnessing the skills of people in the organisation, and upholding of the Australian Public Service (APS) Values and Code of Conduct.

2.8 Using the existing governance frameworks observed within the organisations audited, the ANAO examined the roles, responsibilities and accountabilities between the CEO, executive committee,²⁵ and audit committee. The ANAO considered whether the audited organisations had clearly documented the roles, responsibilities and accountabilities of each of these governance framework components. The ANAO referred to legislative requirements²⁶ and better practice guidance²⁷ when making this assessment.

2.9 The ANAO also examined the accountabilities between the audit committee and the internal audit group, with reference to the specific requirements outlined in the *Financial Management and Accountability Orders 1997* (FMA Orders) and the *Commonwealth Authorities and Companies Orders 2002* (CAC Orders).²⁸

Better practice principles

2.10 Better practice suggests that committees within the governance framework should have charters, or some other form of equivalent documentation, which specifies the:

- authority, and membership, of the committee;
- role, functions, and responsibilities²⁹ of the members and, in particular the chair;
- basic operating protocols;
- processes for identifying and measuring conflicts of interest; and
- policies on committee performance.³⁰

2.11 In particular, the audit committee should be supported by a comprehensive, CEO-endorsed charter, which enhances its effectiveness by serving as a road map for committee members.³¹ In addition to the items listed

²⁵ This term is used to describe the organisation's peak decision-making body, which is responsible for the strategic leadership of the organisation. Other terms could be used such as management board or executive board.

²⁶ Primarily the requirements of the FMA and CAC Acts, as discussed in Chapter 1.

²⁷ ANAO, *The Governance Guide*, op.cit., *Guidance Paper No.5—Monitoring Board Performance*.

²⁸ Refer to p.32 of this Report for a discussion of these requirements and the ANAO's observations.

²⁹ The ANAO notes that all statements of roles, functions and responsibilities should be reviewed periodically, to reflect current mandates, requirements and expectations within the governance framework.

³⁰ *ibid.*, ANAO, pp.2–3.

³¹ Refer to guidance provided at the American Institute of Certified Practising Accountants' website entitled *Audit Committee Effectiveness Center*, at <www.aicpa.org/audcommctr/guidance_resources>.

in paragraph 2.10 above, the audit committee charter should also outline members' competence standards and independence requirements, and authority to access appropriate resources to fulfil its responsibilities.³² Audit committees in Commonwealth organisations will also need to assure themselves of the requirements to fulfil the responsibilities established in the FMA and CAC Orders.³³

Executive and other governance committee charters

2.12 In the organisations audited, governance committees had their responsibilities and roles outlined in some form of documentation. However, the ANAO found that two³⁴ of the organisations audited had not documented formal charters for their executive committee, and two organisations had not documented charters for all of their governance committees.

2.13 The ANAO also found that the level of detail in charters varied. Whilst charters generally articulated the responsibilities, membership, frequency of meetings, and/or reporting requirements, most did not discuss all of these, or the authority, and periodic review cycles for the charters.

2.14 For the two organisations with formal executive committee charters, the accountabilities between the audit committee and the executive committee were documented within the charters.

2.15 The ANAO observed some minor inconsistencies in the delineation of roles and responsibilities documented within committee charters for two of the audited organisations. These observations were observed in relation to risk management and/or governance management responsibilities, as some of the audited organisations had separate business units to manage, or co-manage, these processes.

2.16 The ANAO considers that roles, responsibilities and accountabilities of all committees in the governance framework need to be clearly established to avoid confusion and/or conflict over responsibilities and jurisdictions, as well as for the information of all stakeholders, particularly organisational staff. In addition, the committees may wish to review, periodically, the completeness and currency of their charters, giving consideration to the latest better practice, and changes in their organisations' strategic and operational arrangements.

³² Including funding to obtain legal and professional opinions, authority to access records, personnel or property, and ability to conduct any investigation necessary to discharge its responsibilities.

³³ Refer to p.32 of this Report for a discussion of these requirements and the ANAO's observations.

³⁴ One of these organisations had listed the key responsibilities of the executive committee in its Annual Report.

Recommendation No.1

2.17 The ANAO recommends that Commonwealth organisations clearly document the roles, responsibilities and accountabilities for all of their governance committees.

Audited organisations' responses

2.18 All of the organisations agreed with the recommendation. Specific comments provided by IP Australia were as follows.

- IP Australia supports that clearly documented roles, responsibilities and accountabilities for governance committees will assist in ensuring a well supported corporate governance framework.

Audit committee charters

2.19 The ANAO found that, in accordance with legislative requirements, all of the audited organisations had established an audit committee, which was accountable to the executive committee. The chair of the audit committee was also able to report directly to the CEO.

2.20 In most cases, the audit committee charters were the most extensive of the key governance committee charters. The audit committee charters addressed the legislative requirements,³⁵ and were, generally, in accordance with better practice principles.³⁶

2.21 The audit committee charters also reflected the committees' oversight responsibilities for internal audit and the committees' relationship with the external auditor, as well as their responsibilities for improving and providing assurance regarding the:

- operation of the internal control structure;
- financial reporting process; and
- organisations' compliance with legislative requirements.

2.22 In addition, one audit committee had established an indicative work program within its charter. This assisted in clarifying the responsibilities of the committee, and managing the achievement of all of its stated objectives through proactively managing its workload.

³⁵ These are discussed in greater detail on p.32 of this Report.

³⁶ Including detailing: responsibilities and functions; authority and powers; members; members' competency expectations; observers; meeting frequency; reporting requirements to the CEO.

2.23 The CEO had approved all charters.

Ongoing support for the audit committee members

2.24 The ANAO found that organisations, through the internal audit group, supported audit committee members' in fulfilling these responsibilities by providing induction packages, which contained some relevant information on the organisation's legislative and governance frameworks.

2.25 The ANAO considers that organisations could improve the support for audit committee members, on an ongoing basis, to assist them in maintaining a current understanding of:

- legislative requirements for their organisation; and
- developments in the concept and practice of internal control in a changing environment.

Legislative requirements of audit committees in Commonwealth organisations

2.26 The FMA Orders³⁷ establish functions and responsibilities of audit committees in FMA Act organisations. These include:

- the approval of internal annual and strategic audit plans of the organisation;
- the review of all audit reports involving matters of concern to senior management of the agency, including the identification and dissemination of good practices;
- the provision of advice to the Chief Executive on action to be taken on matters of concern raised in a report of the internal auditors or in a report of the Auditor-General concerning the organisation;
- as far as practicable, the coordination of audit programs conducted by internal auditors and those conducted by the Auditor-General; and
- the provision of advice to the Chief Executive on the preparation and review of financial statements of the organisation.

2.27 The CAC Orders do not explicitly establish functions and responsibilities for the audit committee in CAC Act organisations. However, within the report of operations (section 10) and the governance statement (section 15), the directors are required to report in the annual report on their

³⁷ FMA Orders, sections 2.1.1 and 2.1.2.

responsibilities, and on information relevant to the risks, performance and activities of the organisation for the year.

Audit committees' functions and responsibilities

2.28 The ANAO used the list of functions and responsibilities in the FMA Orders as the basis on which to form a view on audit committees' interaction with the internal audit group in the organisations audited.

2.29 For each of the audited organisations, the ANAO's observations and findings relate to their internal audit work conducted in the 2002–2003 and 2003–2004 audit years, and the development of their 2003–2004 Audit Work Program (AWP).

Approval of internal annual and strategic audit plans of the organisation

Requirement to approve internal audit annual and strategic plans

2.30 All of the audit committees in the audited organisations were required to review and approve the proposed internal AWP.³⁸

Support provided by the internal audit group

2.31 The internal audit groups assisted, to varying degrees, the audit committees' assessment of the adequacy of AWP by:

- prioritising audit topics, based on the organisation-wide Risk Management Plan (RMP) and their own relative, comparative risk assessment;
- clearly documenting the link between the proposed audit topics and strategic risks of the organisations, so that the audit committees could analyse the adequacy of risk and control environment coverage over time;
- assigning audit topics to an audit theme, and distinguishing between performance, compliance or a mix of such products, so that the audit committees could assess whether the audit topics met the priorities of the organisations;
- stating the broad objectives of proposed audit topics, and providing further information on the scope of the proposed audit tasks, so that the

³⁸ The development of AWP is discussed in greater detail in Chapter 4.

audit committees could assess the adequacy of scope of the proposed audit topics;

- noting which outcome and/or business area the proposed audits would assess, so that the audit committees could consider whether the audit coverage was appropriate;
- discussing previous, proposed and future AWP, so that the audit committees could assess audit coverage over time; and
- indicating the estimated staffing requirements against proposed audit topics, and planned timetables for audits, so that the audit committees could assess internal audit staffing requirements, and anticipate and schedule their workloads.

2.32 The ANAO considers that internal audit groups should further assist the audit committees' in their assessment of the proposed AWP, by providing them with documentation which clearly articulates:

- internal audit's comparative risk assessment of the organisation's risks, as identified within the organisation's RMP; and
- the proposed audit objectives, scope, coverage, timeframe and resource requirements.

Recommendation No.2

2.33 The ANAO recommends that, in order to facilitate the objective assessment of the proposed internal audit work program (AWP), internal audit groups provide audit committees with documentation supporting the:

- comparative assessments of risks, and proposed internal audit topics, including definitions for terms used and ratings applied; and
- description of each proposed audit, and an estimation of the timeframe and resource requirements to complete each audit.

Audited organisations' responses

2.34 All of the organisations agreed with the recommendation. Specific comments provided by IP Australia were as follows.

- IP Australia agrees that the audit committee and the audit work plan should address comparative assessments of risk.

Approval of the proposed AWP

2.35 The ANAO found that, in accordance with the requirement stated in their charters, all audit committees reviewed and approved the proposed AWP. Only one audit committee sought the CEO's final approval of the AWP.³⁹ In the other audited organisations, this responsibility was delegated to the audit committee, which, together with the Chief Internal Auditor⁴⁰ (CIA), kept the CEO informed of changes throughout the AWP development process.

2.36 Only two of the audit committees documented the approval of the AWP in the audit committee meeting minutes. One evidenced the discussion of the relative merit of each of the proposed audit tasks in the AWP by the audit committee. The audit committee meeting minutes of the other three audited organisations noted that changes were made to the AWP submitted for approval. However, the minutes did not always record the reason for the changes (for example, based on resource limitations, or coverage of the topic elsewhere in the assurance program).

2.37 The ANAO considers that the audit committee's rationale for approving the AWP, as well as a copy of the approved AWP, should be formally recorded in the audit committee meeting minutes. This would demonstrate the audit committee's consideration of the proposed AWP, and reflect transparent decision-making processes.

Ongoing monitoring of the AWP

2.38 Although not a requirement in the legislation, the ANAO noted that two organisations' audit committees, in consultation with the CIA, conducted a three or six monthly review of the approved AWP to confirm the ongoing relevance of audit topics. This process was not generally documented, unless it resulted in a change to the approved AWP, when proposals were put to the audit committees for formal approval.

2.39 The third organisation's audit committee reviewed the approved AWP annually, and also had scope to include emerging issues in the CIA's programs of other work. The audit committee in the fourth organisation was provided with summaries of internal audit's progress against the AWP, inclusive of any changes, at each meeting for consideration and agreement. Both audit committees documented these considerations.

³⁹ The ANAO would expect, in accordance with professional standards (IIA Standards 2020), that the CEO would also approve the AWP.

⁴⁰ The term is used to describe the head of internal audit. Other titles could be used, such as Director, Internal Audit, Head of Internal Audit, and National Manager Audit.

Recommendation No.3

2.40 The ANAO recommends that audit committees clearly document within the minutes of their meetings the:

- rationale for selecting the approved list of approved internal audit topics;
- approved internal AWP, with evidence of links between the organisation's assessed and prioritised risks and the internal audit topics; and
- nature and outcome of discussions relating to the periodic review of the internal AWP.

Audited organisations' responses

2.41 All of the organisations agreed with the recommendation. Specific comments provided by IP Australia were as follows.

- IP Australia agrees that there is a need to ensure the rationale for selecting the list of approved internal audit topics also addresses the strategic objectives of the organisation.

Review of audit reports, including the dissemination of good practices

2.42 In all audited organisations, the audit committees received completed internal audit reports, or summaries of audit reports with management comments, at each meeting. The minutes of audit committee meetings evidenced discussion of the tabled audit reports. Internal audit groups also provided audit committee members with information, in the time between audit committee meetings, to keep members up to date on internal audit matters, and to manage workloads at audit committee meetings. Generally, this included:

- internal and external audit reports, as they were completed;
- copies of documents amended as a result of a decision at the audit committee meetings; and
- information on issues arising.

2.43 Two of the internal audit groups could evidence that they disseminated good practices and guidance, on behalf of their audit committees, arising from internal and external audit reports, to their senior managers. This also included relevant published better practice guidance.

Advice to the CEO on action to be taken on significant matters and recommendations raised in internal audit, Auditor-General, and/or parliamentary committee⁴¹ reports

2.44 All audit committee charters stated the audit committee's responsibility to brief the CEO and/or executive committee on matters that may significantly impact the operation of the organisation, including matters raised in internal and external audit reports.

2.45 Audit committee charters of all audited organisations confirmed the committee's responsibility⁴² for following up on responses to internal audit, external audit and relevant parliamentary committee reports, including the implementation of recommendations. The responsibility for gathering information to support this analysis had been delegated to the internal audit groups, which received periodic reports from the officers responsible for implementing the recommendations. The delegation of this responsibility is consistent with professional guidance.⁴³

2.46 All audit committee meeting agendas had a standing item requiring a listing of outstanding recommendations, from internal and/or external audit reports, to be tabled at every meeting, or every second meeting. This provided the audit committees with a mechanism to monitor and review the implementation of outstanding recommendations.

2.47 In addition, all audit committees could request the attendance of officers responsible for implementing the recommendations at audit committee meetings, to provide an explanation for delays in the uptake of audit recommendations, and of their planned implementation strategies. One audit committee also checked the validity of the responses provided in the listing. The ANAO considers that this practice should enhance the timeliness, and completeness, of the uptake of audit recommendations.

2.48 The ANAO also considers that, to capture all benefits from external audit reports, the internal audit groups could also review the findings of

⁴¹ While advice on significant matters and recommendations raised in parliamentary committee reports is not specifically identified in the FMA Orders, the ANAO considers that the audit committee would also follow up on the organisation's responses to these reports. Examples of parliamentary committees include the Joint Committee of Public Accounts and Audit (JCPAA), and the Senate Standing Committee on Finance and Public Administration.

⁴² As required under both the FMA Act, and in the Department of Finance and Administration's Finance Circular No: 1999/02, *Follow up of Auditor-General Matters*, June 1999. Finance Circular No: 1999/02 recognises the important role audit committees have as vehicles for independent scrutiny of action on such matters, for both general and specific findings, within a framework of effective corporate governance. It also recommends that the boards of Commonwealth Authorities and Companies extend similar arrangements to their entities. Entities are also encouraged to provide copies of reports to the Auditor-General and the JCPAA.

⁴³ IIA, *IIA Standards*, op.cit., 2500—*Monitoring Progress*.

Auditor-General reports, including cross-agency reports, where the organisation was not audited. Internal audit should then advise the audit committees of the relevant points.⁴⁴

2.49 Despite the actions taken by all audit committees to monitor the implementation of audit report recommendations, the ANAO noted that some of the organisations had a large number of outstanding recommendations, some of which had been outstanding since 2000. All audit committees indicated that they were continually working with their internal audit groups to improve the quality of the listings of recommendations, and to facilitate the timely implementation of outstanding recommendations.

2.50 The listings of outstanding recommendations in three of the audited organisations indicated the audit title and date, the recommendation, responsible officer,⁴⁵ any action being taken towards implementing the recommendation, an estimated implementation date, and an internal audit assessment of the response.

2.51 In the other organisation, work was underway, at the time of audit, to include such information, as the existing listings only indicated the report title and date, and the number of recommendations pending, in progress or actioned.

2.52 Three audit committees prioritised the recommendations on a sliding risk-based scale, to highlight their importance to the organisation. These audit committees also requested summary sheets, or tables, to highlight the spread and number of recommendations outstanding.

2.53 The other audit committee placed equal importance on the implementation of all recommendations, and had not prepared a summary sheet or prioritised the outstanding recommendations. The ANAO recognised that the organisation concerned considered that this approach was appropriate, as it had few outstanding recommendations.

2.54 However, the ANAO considers that, where organisations have many outstanding recommendations, prioritisation assists with utilising scarce organisational resources more efficiently. The ANAO also considers that organisations should periodically review the prioritisation of longer-term outstanding recommendations based on their knowledge of current priorities and exposures.

⁴⁴ Some matters may be noted within audit reports, but not raised as recommendations, either because they are outside the control of the function being audited, or not specifically within the scope of the audit.

⁴⁵ This term refers to the business unit manager or officer responsible for actioning the implementation.

Recommendation No.4

2.55 The ANAO recommends that, in order to facilitate the timely resolution of longer-term outstanding recommendations from audit reports, audit committees prioritise outstanding recommendations, and monitor implementation strategies and progress, commensurate with current assigned priorities.

Audited organisations' responses

2.56 All of the organisations agreed with the recommendation. Specific comments provided by IP Australia and Department of Employment and Workplace Relations (DEWR) were as follows.

- IP Australia supports this recommendation. However, it may be worthwhile to present the audit committee with prioritised outstanding recommendations and the rationale for the priority listing as a starting point for discussion in order to facilitate effective meetings.
- DEWR agrees with the recommendation in principle. It is not clear [to DEWR] what is meant by “longer-term outstanding recommendations”. Often recommendations may take several months to implement. In the case of IT solutions this could extend beyond one year. DEWR’s audit committee monitors audit recommendations until completion. In addition, it would be beneficial if the ANAO could provide some guidance (or methodology) for audit committees to enable them to prioritise recommendations in a consistent manner.

Coordination of the internal and external audit work programs for the audit year

2.57 Each year, internal audit groups develop an internal AWP, which are provided to the audit committees for review. The development of the internal AWP, as outlined in Chapter 4 of this Report, involves the internal auditors discussing proposed audit tasks with the external auditors. This enables the internal and external auditors to avoid duplication in audit coverage, and to coordinate timeframes and access for audit teams. As well, the impact of such activity on the organisation itself can be minimised.

2.58 All audit committees examined in this audit had discussed both the internal and external AWPs at audit committee meetings. The audit committees also monitored AWP progress by liaising with internal and external auditors at the audit committee meetings.

Advice on the preparation and review of the organisation's financial statements

2.59 All audit committees discussed aspects of financial controls and management, and the external audit process, at each audit committee meeting, as a standing agenda item. In addition, a specially convened meeting was held each year, in all audited organisations, to review and discuss the clearance of the financial statements.

Other issues relevant to the audit committees' oversight of the internal audit group

Independence of the audit committee members

2.60 Many of the benefits claimed for an audit committee are predicated on its independence and the objectivity it brings to its deliberations. In the private sector, the membership of an audit committee is comprised wholly, or with a majority, of independent non-executive directors. Often, one of these directors is appointed chairperson of the committee. Although a similar model does exist in certain public sector bodies, the accountability arrangements in FMA Act organisations are such that senior managers from the organisation form the majority of the audit committee's membership base. As a result, audit committees in the public sector cannot be considered to be truly independent from management, although there are ways in which a degree of independence can be achieved.⁴⁶ Nevertheless, there can be conflicts of interest, which have to be managed in a transparent manner.

2.61 By having external representatives on audit committees, organisations increase the opportunity for independent inquiry.⁴⁷ The Auditor-General has been advocating, recently, the advantages of appointing more than one independent (external) member to the audit committee, including giving consideration to the selection of an independent (external) chair.⁴⁸ In particular, the ANAO considers that it is important for the CFO to remain independent of the audit committee, given the assurance sought from the CFO on the adequacy of the financial controls within the organisation, and the ongoing focus, generally, of both external and internal audit on financial controls within the organisation.

⁴⁶ ANAO Better Practice Guide, *Audit Committees*, Canberra, June 1997. Available: <www.anao.gov.au>.

⁴⁷ Northern Territory, Auditor-General's Office, *Overview of Audit Committees in Northern Territory public sector entities*, October 1997.

⁴⁸ Barrett, P *Corporate Governance—a more private public sector*, 29 February 2004, p.42. Available: <www.anao.gov.au>.

Committee membership

2.62 All audit committees had an external member. One organisation's CEO had appointed the external member as chair of the audit committee.

2.63 Of the four organisations audited, two audit committees had their CFO as a participating member. Both audit committees had given special consideration to this particular membership, and had prepared a discussion paper for the CEO outlining better practice guidance on this matter. Both audit committees determined that there was no conclusive reason why the CFO would have any greater conflict than any other internally appointed senior management officer. In addition, one stated that, 'on balance', there was a need for this membership in order to strengthen the financial literacy of the audit committee.

2.64 However, the ANAO notes that having the CFO as a member of the audit committee is inconsistent with better practice principles in the private sector,⁴⁹ and uncommon in the public sector.⁵⁰ Within the public sector, it is more common for the CFO to be invited to attend segments of the audit committee meeting as an observer and respondent, to comment on matters where the audit committee deem this officer's expertise to be required. This would be the preferred approach. To access the required financial literacy skills, the CEO may consider appointing more than one external member to the audit committee.

Conflict of interest protocols

2.65 An actual, or perceived, conflict of interest and/or role can be managed by committee protocols, which provide for committee members to exclude themselves from committee discussions, where conflict exists.⁵¹

2.66 Three of the four audit committee charters examined did not discuss mechanisms for managing conflict of interest and/or role. The ANAO considers that there is an opportunity for organisations to document additional guidelines to improve the objectivity and independence⁵² of their audit

⁴⁹ The ANAO refers organisations to the KPMG Publication *Audit Committee Toolkit—an essential guide*, Melbourne, November 2003, p.42.

⁵⁰ Whilst a formal survey has not been conducted on this issue, the ANAO reviewed the audit committee memberships of a sample of its audit clients (47). Approximately 23% of organisations in the sample have their CFO as a participating member. A large number of these were small organisations, where there were limited other resources available. For the other 77% of organisations in the sample, the CFO typically attends the meetings at the request of the audit committee or as an observer.

⁵¹ ANAO *The Governance Guide*, op.cit., *Guidance Paper No.4—Executive Boards in FMA Agencies* and *Guidance Paper No.6—Conflicts of Personal Interest and Conflicts of Role*.

⁵² This includes having guidelines for the ethical conduct of members selected to the committee. These guidelines could be worded to avoid independence and objectivity issues from arising, for instance requiring a member with a potential conflict of interest to excuse themselves from discussions, or the particular meeting, if necessary.

committees. As a minimum, and in accordance with better practice principles,⁵³ audit committee members should be required to:

- make a distinction between their responsibilities as committee members, and their normal management responsibilities; and
- advise of potential conflicts, and be excluded, as necessary, from the related discussion.

Internal audit resourcing

2.67 Implicit in the audit committees' act of approving the proposed AWP,⁵⁴ is the need to consider and provide the internal audit group with appropriate staffing and funding to achieve the program of work.

2.68 The ANAO found that all audit committees in the audited organisations had identified their responsibilities for reviewing and approving the staffing for the internal audit groups. In addition, two organisations had documented their staffing profile in a workforce planning document and/or a business plan. However, little documentation was maintained by the audit committees in support of the analysis of the adequacy or sufficiency of resource requirements in two of the audited organisations.

2.69 The ANAO found that the audit committees were not held responsible for approving the internal audit groups' budgets. These approvals were provided as part of the organisations' annual budget approval processes, which occurred several months before the AWP development process.

Conclusion

2.70 The ANAO found that all audited organisations had established a governance framework in which key committees and officers are identified. Documented charters, policies and procedures, generally supported the roles and functions of the committees. Most governance committees had established formal charters outlining their authority, role and purpose. However, some charters had inconsistencies in content, specifically with regard to delineation of responsibilities. On the other hand, the ANAO noted some committees did not have formalised charters.

2.71 The ANAO found that all audited organisations had audit committee charters which were largely consistent with better practice guidance, and

⁵³ The ANAO refers organisations to the ANAO Better Practice Guide *Public Sector Governance*, – *Guidance Paper No.6, Conflicts of Interest and Conflicts of Role*, July 2003 for further guidance on managing conflicts of interest and / or role in the public sector.

⁵⁴ As discussed earlier on p.33.

which articulated the role audit committees play in assurance and control activities. The charters were approved by the CEOs. Minutes of audit committee meetings generally evidenced that the committees:

- regularly discussed matters relevant to the accountability and control frameworks of the organisations;
- monitored and pursued the implementation of recommendations; and
- actively oversaw the operations of the internal audit group.

2.72 The ANAO considered, however, that audit committees could improve their record-keeping practices to support their objective and transparent decision-making processes. Organisations could also consider involving a higher level of external representation on their audit committees to heighten independence.

3. The Role of Internal Audit

This Chapter explains that an effective and value-add internal audit group requires the support of the executive management, and a clearly articulated policy to support and direct its mandate and independence within the governance framework.

Introduction

3.1 The role, responsibility, authority and scope of work for the internal audit group should be formally defined within a charter, which is consistent with professional guidance, and has been approved by the CEO.⁵⁵ The charter should be reviewed periodically to assess the relevance of the internal audit group's stated role to the organisation.

3.2 The decision regarding the role of internal audit will be determined by a number of factors,⁵⁶ which may change over time. These factors may include the size and complexity of the organisation and the status of the internal audit group within the governance framework. The audit committee will also influence the role of internal audit. The scope of the internal audit group's work generally includes providing assurance over compliance with legislative requirements and the adequacy and operation of the internal control framework. It may also assess the effectiveness and efficiency of programs and functions, including risk management, financial management, and business planning.⁵⁷

3.3 Whilst not having the same strict requirements and definition of independence as that of external audit, internal audit needs to demonstrate that it is *free from conditions that threaten objectivity or the appearance of objectivity*.⁵⁸ In addition, it needs to carefully manage the tension between internal auditors reviewing and promoting organisational priorities and activities, and the act of establishing and implementing them. If independence is not maintained, the credibility of its work may be brought into question. Typically, independence for the internal audit group is established through requirements for quality control and adherence to professional standards.

⁵⁵ IIA, *IIA Standards*, op.cit., 1000—*Purpose, Authority and Responsibility*.

⁵⁶ Refer ANAO, *The Internal Audit Guide*, op.cit., for an explanation of factors to consider from pp.25–43.

⁵⁷ *ibid.*, *IIA Standards*, 2100—*Nature of Work*.

⁵⁸ *ibid.*, *Glossary*.

Better practice principles

3.4 Better practice⁵⁹ suggests that the internal audit group should be supported by a comprehensive and endorsed charter, which establishes its role, responsibilities, authority and standards for operation. Specifically, the charter should outline the group's:

- roles and responsibilities,⁶⁰ including those of the CIA;
- authority, access and liaison provisions;
- independence, professional standards and competence requirements;
- operating and reporting⁶¹ protocols for audit work; and
- basis for reviewing its performance.⁶²

Internal audit groups within audited organisations

3.5 All audited organisations had established an internal audit group (see Figure 2.1, in Chapter 2). The CEOs had appointed a CIA to manage the internal audit group. The CIAs typically reported to both the CEO and the audit committee.

Internal audit charters

3.6 For the audited organisations, all internal audit groups had documented an internal audit charter. The ANAO examined the internal audit charters applicable to the 2003–2004 audit year.

3.7 Three internal audit charters had been approved by the audit committees, with one charter being approved by the CEO. The internal audit charters provided the internal audit groups with the authority to access any resources necessary to undertake their roles. In addition, three of the audited organisations had validated the role of internal audit within their Chief Executive's Instructions (CEIs). This helped to confirm the authority and importance of internal audit by establishing 'tone from the top'.

⁵⁹ ANAO, *The Internal Audit Guide*, op.cit., pp.46–51.

⁶⁰ As with the governance committee charters, all statements of roles and responsibilities should be reviewed periodically, to reflect current mandates, requirements and expectations within the governance framework.

⁶¹ Reporting requirements are discussed in Chapters 2 and 5.

⁶² The evaluation of internal audit is discussed in Chapter 6 of this Report.

3.8 The ANAO found that all internal audit charters were largely in accordance with the better practice guidance principles noted in paragraph 3.4 above. The ANAO's observations and findings, as they relate to these principles, are discussed below.

Role of internal audit

3.9 All internal audit charters identified that the internal audit groups existed to provide independent review, objective assurance and advisory services to the CEO and senior management, and to improve the performance and accountability in organisational systems and practices within a sound risk management environment. This objective was also reflected in the business plans for the in-sourced groups,⁶³ where efforts had been made to demonstrate the link between the groups' activities and the organisations' outcomes.

3.10 In three of the audited organisations, the focus of audit work was to support the strategic objectives of the organisation. Audit work included a larger percentage of business improvement and performance assessment work, than just financial and/or compliance audits. Two of these organisations could demonstrate that this strategic focus was the result of decisions arising from structured governance reviews.

3.11 In the fourth organisation, the AWP comprised a mix of compliance and performance audits, and had been structured to address the key control risks and themes identified by internal audit during the development of the proposed AWP. In response to a request from the CEO, the AWP also included a small number of specific audits of administrative compliance.

3.12 The ANAO noted that the internal audit groups in two of the audited organisations had adopted, within their internal audit charters, descriptions of their roles directly from better practice guidance. However, these roles did not necessarily meet their organisations' specific or actual requirements. One of these organisations acknowledged that its internal audit charter required review. However, the organisation considered that the functions set out in the charter still reflected the organisation's requirements, and internal audit's activities.

3.13 The ANAO considers that there is an opportunity for Commonwealth organisations to demonstrate the consideration of their specific requirements for their internal audit groups, in the wider organisational context, when next reviewing the role of their internal audit groups. Guidance on this is available in better practice publications on both internal audit and the assessment of

⁶³ An in-sourced internal audit group is one which is part of the organisation structure (that is, not a contracted service), and is staffed by organisation employees.

control structures.⁶⁴ In particular, and in accordance with better practice guidance,⁶⁵ the audit committee and internal audit could document their rationale for the most appropriate role for the internal audit group with regard to:

- the effectiveness of the control environment;⁶⁶ and/or
- developments in the auditing profession or changes in public sector operations or priorities.

3.14 By failing to consider and monitor these developments, Commonwealth organisations may be exposed to governance deficiencies, which may have an adverse impact on compliance with legislation, financial reporting and operational performance.

Responsibilities of the internal audit group

3.15 The internal audit charters, in all audited organisations, established the internal audit groups' responsibilities and services. Internal audit groups listed their key responsibility as supporting the assessment of the adequacy and effectiveness of the risk management, controls and governance frameworks, as well as ensuring compliance with legislative and other requirements. This was achieved through:

- developing and implementing a risk-based AWP, which is approved by the audit committee;
- conducting audits as requested by the CEO and executive committee, or those requests initiated by senior managers, providing these later requests are approved by the audit committee;
- monitoring and reporting on the status of the AWP, and actions taken towards implementing outstanding recommendations; and
- liaising with the external auditors to avoid duplication in effort, and co-ordinating the organisations' responses to external reports.

3.16 Some of the internal audit groups also had responsibilities for:

- assessing and expressing an opinion on aspects of the design, development, implementation and operation of systems, procedures,

⁶⁴ Including ANAO, *The Internal Audit Guide*, op.cit., and ANAO Better Practice Guide, *Controlling Performance and Outcomes—Control Structures in the Commonwealth Public Sector*, December 1997 Available:< www.anao.gov.au>, as well as numerous other better practice guides in the private sector.

⁶⁵ ANAO, *The Internal Audit Guide*, op.cit., pp.28–31.

⁶⁶ Elements to consider as part of this assessment are outlined in the discussion on the AWP development process in Chapter 4.

processes and controls, as well as reviewing aspects of the financial statements;

- assisting in fraud investigations and/or maintaining fraud reporting systems;
- assisting managers to meet their quality assurance responsibilities;
- reviewing and clearing all program guidelines; and
- assisting in fostering, in the organisation, an understanding and knowledge of audit issues and best practice.

3.17 The ANAO considered that some of the internal audit charters could better clarify how the internal audit groups achieved their stated activities, or at least provide references to where an explanation of these activities existed. The ANAO also considered that internal audit groups could better clarify the delineation of responsibilities between themselves and other stakeholders in relation to activities where there were joint responsibilities, including in relation to governance and risk management.

CIA responsibilities

3.18 The ANAO found that the tasks and activities of the CIA closely aligned with the responsibilities of the internal audit group, as expressed in the internal audit charters. In all organisations audited, the CIA had access to, and regularly consulted with, the CEO, Deputy CEO(s), the audit committee and senior managers. This provided the CIA with a broad appreciation of departmental priorities, programs and issues. In one organisation, the CIA also attended organisation-wide risk management forums, which gave the CIA a better understanding of organisation-wide risks.

Independence of the internal audit group

3.19 All internal audit charters stated that the independence of the internal audit group, as well as of its staff, was important for the operation and integrity of internal audit. Only one internal audit charter did not explicitly state the independence requirements of the internal audit group and/or audit staff.

3.20 Professional standards indicate that the CIAs must not audit functions for which they had responsibilities in the previous year, and should report immediately any situation in which a conflict of interest, or role, is present. None of the internal audit groups examined had provisions within their internal audit charters to clarify, or manage, this requirement. However, one organisation advised that its CIA was bound by the organisation's CEI on conflict of interest.

3.21 The ANAO also notes that the appearance of independence for internal audit staff (as distinct from external audit, where independence is typically assessed by employment or past work relationships) can be enhanced by having:

- a sound quality assurance program; and
- a transparent review and evaluation of its work by the audit committee.

3.22 These matters are discussed in greater detail in Chapters 5 and 6 of this Report.

Other matters noted in the internal audit charters

3.23 The internal audit charters of the audited organisations also typically outlined the internal audit groups’:

- management protocols for the delivery of audit reports;⁶⁷
- reporting requirements to the audit committee and/or CEO;⁶⁸
- requirements to liaise with external audit (to facilitate the audit process and monitor the uptake of recommendations);⁶⁹ and
- requirement for a quality assurance process.⁷⁰

3.24 However, the internal audit charters in two or more of the organisations audited, did not clearly establish, or refer to:

- competency expectations and professional standards requirements for audit staff when undertaking audit work;
- term of tenure, or appointment, for the CIA; nor
- annual review requirements for the charter.

⁶⁷ Discussed in Chapters 2 and 5.

⁶⁸ Discussed in Chapter 2.

⁶⁹ *ibid.*

⁷⁰ Discussed in Chapter 5.

Recommendation No.5

3.25 The ANAO recommends that internal audit groups review the completeness and currency of their charters, to establish guidance on, and mechanisms for, the effective and efficient operation of the internal audit group within the broader governance framework.

Audited organisations' responses

3.26 All of the organisations agreed with the recommendation.

Conclusion

3.27 The ANAO found that all audited organisations had documented internal audit charters, which were largely consistent with professional requirements and better practice guidance. The internal audit charters articulated the internal audit groups' roles, responsibilities, and accountabilities to the CEO and audit committees. The internal audit charters were supplemented by business plans and other procedures, some of which provided a high-level summary of the groups' key activities. Three of the audit committees approved the internal audit charters, with one charter being approved by the CEO on the recommendation of the audit committee.

3.28 However, the ANAO considers that the internal audit charters could be improved by including the internal audit groups' delineation of responsibilities with key stakeholders, as well as the competency and professional requirements for internal audit staff. The ANAO also considers that the audit committees could better document their rationale, and agreement with the CEO, on the approved role for the internal audit group. Undertaking this process, in accordance with better practice guidance, may assist some organisations with the clarification of internal audit work priorities and achieve better outcomes for the organisation.

4. Developing the Internal Audit Work Program

This Chapter of the Report discusses approaches and practices adopted by internal audit groups to identify value-add products and services. It explains that to add value and be effective, internal audit will need to develop a risk-based AWP that satisfies its stakeholders' requirements. The internal audit group may identify services other than audits, to assist with providing assurance, or improving, the risk, control or governance frameworks, as well as aspects of the organisation's performance.

Introduction

4.1 In order for internal audit to provide assurance over the organisation's compliance with legislation, and the adequacy and operation of the organisation's controls and processes, it must adopt a sound planning approach to identify potential topics, and the most appropriate products and/or services to address those topics.

4.2 Key to the development of the program of work for internal audit is the need to balance appropriately the two main governance requirements,⁷¹ namely performance⁷² and conformance.⁷³ Risk management should underpin the organisation's approach to achieving both performance and conformance objectives. An integrated risk management approach is critical to the development of a control environment, which provides reasonable assurance that the organisation will achieve its objectives with an acceptable degree of residual risk.⁷⁴

4.3 As part of this process, the internal audit group should review relevant documentation, and liaise with internal stakeholders⁷⁵ to identify systems, processes, risks, and priorities. Liaison with external auditors should also occur, to eliminate duplicate work coverage, and identify opportunities for the

⁷¹ ANAO, *The Governance Guide*, op.cit., Volume 1, Framework, Processes and Practices, p.6.

⁷² Performance is concerned with control and governance arrangements, which contribute to an organisation's overall performance and the delivery of its goods, services or programs.

⁷³ Conformance is concerned with control and governance arrangements used to meet the requirements of the law, regulations, published standards and community expectations of probity, accountability and openness.

⁷⁴ Residual risk being the risk remaining after management takes action to reduce the impact and likelihood of an adverse event, including control activities in responding to a risk.

⁷⁵ Including the risk management advisory unit, business planning unit(s), operational business units, and other assurance committees and/or functions.

auditors to rely on one another's work. By doing this, organisations should benefit through:

- economies of scale and greater effectiveness for both internal and external auditors;
- leveraging from external audit expertise and internal audit business knowledge to produce higher quality, and better targeted, audit products; and
- developing a better understanding of the risk, governance and control frameworks in shorter timeframes, and a greater level of assurance for the organisation.

Better practice principles and professional guidance

AWP development

4.4 Professional requirements state that, each year, internal audit should adopt a structured planning approach to identify and document its priorities for internal audit assurance and advisory activity for the following year.⁷⁶ In accordance with better practice and professional guidance, this is the responsibility of the CIA, who will develop a risk-based program of potential audit topics, and/or other services, consistent with the organisation's goals and the role of the internal audit group, as documented within the internal audit charter.⁷⁷

4.5 For audit work, the proposed program of audits, including their scope, objectives, timing and resource allocations should be documented within an AWP.⁷⁸ The AWP should be reviewed by the audit committee, and recommended for approval to the CEO.⁷⁹ The approved AWP should also be communicated to the executive management.⁸⁰ The AWP should be reviewed periodically in light of audit findings, and changes to the organisation's risk and control environments.

⁷⁶ IIA, *IIA Standards*, op.cit., 2010—*Planning*.

⁷⁷ *ibid.*, and ANAO, *The Internal Audit Guide*, op.cit., p.32

⁷⁸ IIA, *IIA Standards*, op.cit., 2200—*Engagement Planning*.

⁷⁹ *ibid.*, 2020—*Communication and Approval*, and ANAO, *The Internal Audit Guide*, op.cit., p.32.

⁸⁰ *ibid.*, *IIA Standards*.

Other internal audit services

4.6 The internal audit group may also provide products and services, which promote or improve the organisation's risk management, control framework or level of compliance with legislation. The nature of these services should be defined in the audit charter,⁸¹ and should not impair⁸² the auditor's objectivity⁸³ or independence.⁸⁴

Structured planning approach

4.7 For each of the audited organisations, the ANAO assessed the development of the 2003–2004 AWP, as developed by the internal audit groups.

4.8 All internal audit groups in the organisations audited demonstrated that they had adopted a structured planning approach to identify key control themes and related risks across the organisations' business units.

4.9 One internal audit group had prepared a paper describing its structured planning approach, which it provided to the audit committee for information and comment prior to starting the planning process. In the other organisations, the planning process was described (in varying detail) within the proposed AWP, when it was submitted to the audit committee for review.

4.10 The structured planning approaches included internal audit groups reviewing:

- their organisations' business directions, processes, controls and risks as articulated in business plans and risk assessments, or as expressed during stakeholder consultations;
- previous AWP, to identify audits which should be carried over to the new programs, or which impact on the selection of topics for the future; and
- the outcomes of an environmental scan of external pressures and changes (for example, Joint Committee of Public Accounts and Audit

⁸¹ *ibid.*, 1000—Purpose, Authority and Responsibility.

⁸² *ibid.*, 1130—Impairments to Independence or Objectivity.

⁸³ Objectivity refers to the *unbiased mental attitude that allows internal auditors to perform engagements in such a manner that they have an honest belief in their work product and that no significant quality compromises are made*. Refer IIA, IIA Standards, op.cit., Glossary.

⁸⁴ Independence refers to the *freedom from conditions that threaten objectivity or the appearance of objectivity. Such threats to objectivity must be managed at the individual auditor, engagement, functional and organisational levels*. Refer IIA, IIA Standards, op.cit., Glossary.

(JCPAA) and ANAO reviews and recommendations), which have the potential to impact on the AWP.

4.11 A general overview of the inputs, outputs and timings for the AWP development activity across the audited organisations is shown in Figure 4.1.

Links to risk management and business planning

4.12 In undertaking the first step noted in paragraph 4.10, three internal audit groups reviewed their organisations' current strategic risk profile, to confirm risk priorities.

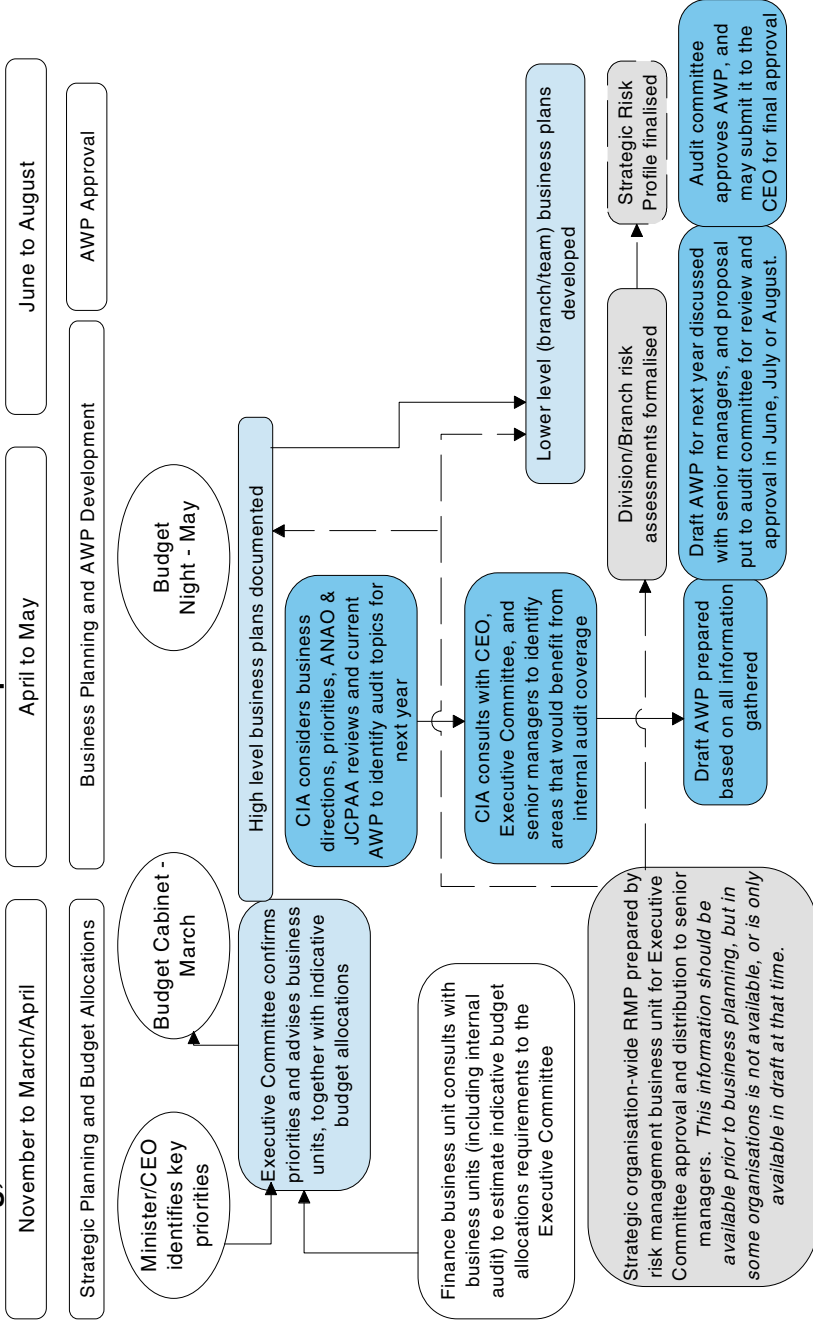
4.13 The other organisation audited indicated that it did not currently have an organisation-wide RMP. It was also still revising and improving its business planning framework and plans following a governance review it had conducted during 2002. As a result, the internal audit group indicated that it undertook its own assessments and consultations with the organisation's executive and senior management to identify risk and control themes. This process had been adopted so that the proposed AWP reflected, to the extent possible, organisation-wide risks and priorities when presented for the consideration of the audit committee. However, the absence of complete and prioritised risk and business plans, which have been endorsed by executive management, limited the internal audit group's ability to gain assurance that its risk assessment and AWP were complete and consistent with agreed organisation-wide priorities.

4.14 As shown in Figure 4.1, organisations had identified that the completion of the risk management and business planning processes were the joint responsibility of the operational business units, and specialised risk and/or business planning advisory units, respectively.

4.15 The AWP development process was generally undertaken concurrently with the organisation-wide risk management and business planning processes. This facilitated the timely attention to current strategic risk and business priorities. It assisted with achieving management support for the internal audit process as senior managers could clearly see the link between the audit process, risk exposures, and the improvement of (or assurance over) the operation of their systems and processes. It also gave senior managers the opportunity to comment on the timing and nature of audit work, and encouraged them to use internal audit as a management tool either to undertake assurance work or provide advice.

Figure 4.1

Business Planning, Risk Assessment and AWP Development



Source: Prepared by the ANAO based on information in the audited organisations' governance policies.

Consultation with internal stakeholders

4.16 The first step of the structured planning approaches also included all internal audit groups consulting with key stakeholders.

4.17 Internal stakeholders were generally advised ahead of time about the nature and purpose of the consultations. Two of the internal audit groups had developed a comprehensive paper explaining:

- the AWP development process;
- the link between the business plan, risk assessments and AWP development process; and
- that submissions would need to be considered in the context of those processes, to identify those areas, which would benefit from internal audit activity.

4.18 In two organisations, a copy of the ANAO draft AWP for 2003–2004 was provided to stakeholders prior to consultations, so that stakeholders could determine whether the ANAO had already stated its intention to audit a system or process. In two organisations, senior managers were also provided with a list of internal audits conducted over the past three to five years, to highlight previous coverage.

4.19 Internal stakeholder consultation generally involved the CIA, or out-sourced⁸⁵ internal audit service provider, meeting with the CEO,⁸⁶ executive management and/or senior managers to confirm strategic and business risks, and business directions and priorities. The CIAs generally also attended forums or working groups to observe developments in risks and/or business practices across the organisations. This assisted the CIAs to develop a sound understanding of their organisations' risks, and business systems and processes, which assisted in developing targeted AWPs.

4.20 Internal stakeholders advised the ANAO that they were generally satisfied with the consultation process, as it allowed them to provide contextual information regarding the maturity, nature or scheduled changes to systems or business activities. It also enabled them to advise of other reviews or consultancies, which had, or were scheduled to, occur. Stakeholders

⁸⁵ An out-sourced internal audit group is one in which all internal audit resources are sourced from outside the organisation, typically on contract for a period between one and three years. The role of CIA may or may not be retained in-house.

⁸⁶ The CEO also tends to make recommendations or requests for audit topics on an adhoc basis. All organisations handled these requests differently. One assigned up to 30 % of its internal audit budget to deal with these requests. The others tended to seek further resourcing to address the topic(s), or reprioritised and rescheduled existing audit work.

indicated that they could provide additional comments at any stage during the AWP development, or implementation, processes.

4.21 In two of the audited organisations, internal stakeholder consultation also involved meeting with other assessors or investigators, who may conduct complementary or similar assurance work.

4.22 The ANAO expected that there would be documentation maintained to support the matters raised, and decisions made, from this ongoing consultation process. However, the ANAO found that organisations maintained little formal documentation from stakeholder consultations, or of other discussions internal audit may have had with stakeholders (for example, through attendance at forums or other meetings).⁸⁷

Consultation with external stakeholders

4.23 In addition to internal stakeholders, the CIAs, or out-sourced internal audit service providers, advised that they also met with, or considered input from, external stakeholders, such as, the JCPAA, ministers and external auditors. All of the internal audit groups periodically reviewed the ANAO's AWP, and met with external financial statement auditors, to minimise the potential for duplication in audit effort. One internal audit group demonstrated that it had worked with the ANAO to eliminate duplication of coverage for a performance audit topic that appeared in both the ANAO's and the internal audit group's AWP's. However, there was generally limited documentation maintained of discussions between the external financial statement auditors and the internal audit group.⁸⁸

Proposed audit topics

4.24 Following the review of the risk and business plans, and stakeholder consultation, the internal audit groups in the audited organisations developed a list of potential audit topics.⁸⁹ The ANAO examined the methodologies used by internal audit groups to select the most appropriate mix of audit products.

⁸⁷ Refer to Recommendation No.6, in Chapter 5.

⁸⁸ *ibid.*

⁸⁹ Internal audit groups may have identified services, other than audits, to address risk and control themes. An overview of these other services is provided from p.59.

4.25 Audit topics were then subjected to a comparative assessment by internal audit, against a series of assessment categories,⁹⁰ to develop a shortlist of potential audit topics.

Topic selection and product mix methodologies

4.26 As noted previously, the role of internal audit and the mix of audit products, should be influenced by the effectiveness of the governance and control frameworks, as well as by the elements of the frameworks that are in place or being implemented.⁹¹ In general, compliance and assurance audit products will assist with improving weak governance and control frameworks. Organisations with strong governance and control frameworks will benefit from audits that seek to improve the efficiency and effectiveness of systems and processes in place.

4.27 All audited organisations indicated that the planning approaches adopted, including the stakeholder consultation process discussed above, guided the selection of the most appropriate audit topics by first identifying risks, and then grouping these into audit themes.⁹² In addition, the internal audit groups in three of the audited organisations had separately identified that risk management and record-keeping practices were high-risk business processes for their organisations, and had incorporated these themes, where appropriate, into audits listed within their AWP.

4.28 All internal audit groups indicated that most appropriate product mix between compliance audit, performance audit, or other products or services were determined on a case-by-case basis, in conjunction with the audit committee and/or business units. The decision was influenced by the type of risk exposure, the desired outcome from the review, the availability and skills of resources (including budget), and the timeframe for the review.

4.29 However, the ANAO did not observe documentation that supported this analysis and decisions in all organisations audited. The ANAO considers that there is an opportunity for organisations to improve the completeness of documentation in support of this process, for transparency, accountability and review purposes.⁹³

⁹⁰ The number of categories for organisations vary, but broadly dealt with the likelihood, impact and management interest in the potential topic. For example: budget impact; community / political exposure; previous or concurrent audit coverage; fraud concern; and strategic or business risk rating.

⁹¹ The elements of the control structure are outlined in *The Internal Audit Guide*, op.cit., p.26.

⁹² These included: contract management, service delivery management, procurement management, financial management, compliance with legislation and internal procedures, and information technology availability and management.

⁹³ Refer to Recommendation No.6, in Chapter 5.

Comparative risk assessments

4.30 The internal audit groups' comparative risk assessment process were formalised and supported by documentation in three of the organisations audited. In two of these organisations, most of the assessment categories had measurement criteria and weightings established to aid with the determination of individual and overall risk ratings for each audit topic. In the other organisation, the AWP indicated whether the assessment category was relevant, but did not indicate a rating.

4.31 The ANAO considers that there is an opportunity for internal audit groups to improve the completeness and clarity of documentation in support of the assessment criteria and weightings. In addition, internal audit groups could generally improve the transparency of the linkage between their ratings of audit topics (in the proposed AWP) and the organisations' agreed risk ratings (in the organisations' RMP), to demonstrate that the relative risk/priority rating for each audit is consistent with the executive committees' views.⁹⁴

4.32 Internal audit groups could also better document the decision rationale for their selection of the shortlist of audit topics (based on their comparative assessments and their resource limitations), which should be included in the proposed AWP when it is submitted to the audit committee for review and approval.⁹⁵

Other internal audit services in audited organisations

Evaluations

4.33 The internal audit group in one of the audited organisations identified the use of evaluations for those areas where a change in the nature or priority of business operations was being sought. This work was undertaken as part of a separately approved work program, and generally involved the use of staff from the area being evaluated. It did not involve the use of audit staff from the out-sourced internal audit service provider.

Education and awareness

4.34 The internal audit groups of two audited organisations provided educational or advisory services to senior managers. For example, the groups

⁹⁴ These matters were raised in Recommendation No.2, in Chapter 2.

⁹⁵ *ibid.*

provided services, which assisted with the application of ethics, control framework and/or fraud control principles.

Fraud control planning and investigation

4.35 The internal audit groups in two of the audited organisations had some role in fraud control planning and the monitoring of fraud investigations. In one of these organisations, the fraud control plan, and approval of it, was recorded in the audit committee meeting minutes. In the other organisation, the results of the last comprehensive fraud risk assessment were reported to the audit committee in July 2003. This report identified areas for further detailed fraud risk assessment in 2003–2004. The ANAO was advised that the draft 2004–2005 AWP included a number of specific fraud risk assessments to examine identified fraud risks.

Control self assessment

4.36 The internal audit group in one audited organisation had recently completed the development of a Control Self Assessment (CSA) toolkit. The purpose of the CSA toolkit was to assist executive management, senior managers and staff to understand, and assess compliance with, the control framework, and, over time, improve business planning and management. The toolkit extended the scope of the current financial self-assessment process (management representation letters), by considering aspects of business management, information and records management, infrastructure management and people management.

Approval of the internal audit group's work program(s)

4.37 As discussed in Chapter 2,⁹⁶ the ANAO found that all proposed AWPs, and other work programs, where relevant, were submitted to the audit committees for review and approval.⁹⁷

⁹⁶ Refer to p.33.

⁹⁷ The ANAO notes that while better practice suggests that the audit committee does not have executive powers to approve actions, under section 2.6.1 of the FMA Orders, the *Chief Executive of an Agency may, by written instrument, delegate to an official any of the Chief Executive's powers and functions under these Orders*. The ANAO found that all audit committees had been delegated the power to approve the internal audit work program via the audit committee charter.

Conclusion

4.38 The ANAO found that all of the internal audit groups examined had adopted a structured and consultative planning approach to develop a risk-based AWP for the 2003–2004 audit year. The ANAO considered that documentation in support of the risk assessments, consultations with stakeholders, proposed audit topic scope and coverage, and product mix could be improved to support the transparency of the AWP development process.

5. Delivering the Internal Audit Work Program

This Chapter of the Report discusses approaches and practices adopted by internal audit groups to manage the delivery of value-add audit products to their organisations. It explains that, to deliver a quality and timely outcome for the organisation, the group needs to adopt sound technical, record-keeping, management and quality control procedures.

Introduction

5.1 Once the AWP has been approved, internal audit will need to manage the delivery of the audit products. This will require adequate resources to be made available to the internal audit group, and sound management of both resources and audit tasks. In addition, audit staff will need to adopt and adhere to appropriate work practices, so that executive management can have confidence in the quality and integrity of the work produced.

5.2 The underlying objective when resourcing the internal audit group is to achieve an appropriate balance of skills, knowledge and background to enable the delivery of an integrated, cost-effective internal audit service.⁹⁸ The appropriate resourcing profile will be directly affected by the scope and mix of products outlined in the AWP, as this will dictate the group's need for resources and skills.⁹⁹

5.3 There will also be the challenge of finding, retaining and managing the desired resources. Typically, the resources cannot be solely sourced from within the organisation and, therefore, there may be a need to seek additional, or all, resources from an out-sourced service provider. While out-sourcing the delivery of all or part of the group provides access to appropriately competent and experienced audit staff, there are a number of challenges, which will need to be managed. These include managing limited budgets, knowledge of public sector requirements, contract management, and the potential for conflict of interest within, and between, clients.

5.4 In order to produce a high quality and reliable audit product, executive management must have confidence that internal audit is applying systematic and disciplined standards of practice when conducting its work. These standards should cover technical and legal compliance, ethical behaviour, as

⁹⁸ ANAO, *The Internal Audit Guide*, op.cit., p.34.

⁹⁹ For example, skills in financial compliance, legislative compliance, and/or management practices to achieve operational efficiency and effectiveness for a specific business system or process.

well as sound management processes designed to facilitate adequate planning, conduct, record-keeping, quality assurance and communication protocols to support audit work.

Better practice principles and professional guidance

Staffing and resource management

5.5 The internal audit group needs to be appropriately resourced with competent¹⁰⁰ staff. Internal auditors should possess the knowledge, skills and other competencies needed to perform their individual responsibilities.¹⁰¹ Where these resources are not available internally, the CIA should obtain competent advice and assistance from external parties. This may be done on an individual audit task basis, or may involve the partial, or complete, out-sourcing of the internal audit activity to a competent service provider.

5.6 In accordance with professional standards, the CIA is required to manage the internal audit resources in such a manner that there are appropriate numbers of skilled resources, which are deployed effectively to achieve the approved AWP.¹⁰² At the individual audit task level, this means assigning appropriate resources to the task commensurate with the nature and complexity of the task, and within the timeframe and resource constraints available.¹⁰³ These activities should be supported by complete and current documentation relating to the profiles and commitments of the internal audit staff.

Practice management

5.7 Professional guidance for the conduct of internal audit work provides a sound basis for the development of internal guidelines. The IIA Standards provide attribute, performance and implementation standards, which specifically guide the behaviour, scope and quality control of internal audit assurance and advisory work. In addition, organisations' own code of conduct may also impact on the scope and conduct of internal audit work. The CIA is

¹⁰⁰ Areas of competence typically include: internal control structures; financial compliance and reporting; fraud risk analysis; information technology risks and controls; control self-assessment; and legislative compliance.

¹⁰¹ IIA, *IIA Standards*, op.cit., 1210—*Proficiency*.

¹⁰² *ibid.*, 2030—*Resource Management*.

¹⁰³ *ibid.*, 2230—*Engagement Resource Allocation*.

responsible for establishing policies and procedures to guide the internal audit activity.¹⁰⁴

5.8 Internal auditors should maintain records of relevant information to support audit conclusions, and demonstrate that these conclusions are based on appropriate analysis and evaluations.¹⁰⁵ This will involve ongoing monitoring and review of auditor's work, and a quality assurance program, to ensure the veracity of audit work.

5.9 The CIA will also need to ensure that the results of audit work are communicated to all appropriate parties in a complete, accurate, concise and timely manner.¹⁰⁶

Staffing the internal audit group in audited organisations

5.10 The ANAO examined the staffing of the internal audit groups for the 2003–2004 audit year. Of the four organisations audited, the ANAO found that two organisations had co-sourced¹⁰⁷ internal audit groups, with a mix of in-house staff and out-sourced service providers. The other two organisations audited had completely out-sourced their internal audit groups.

Co-sourced solutions

5.11 The organisations with co-sourced internal audit groups had a number of in-house staff. The in-house audit staff devoted their time to audit planning, managing internal and external relationships, and undertaking some audit and other assurance work.

5.12 These organisations used out-sourced resources to supplement their own in-house staff, primarily due to the number of audits to be conducted and the inability to find, and retain, a suitable number of appropriately skilled and experienced in-house resources to undertake all work in the approved AWP.

5.13 In one of the organisations, the CEO had recently demonstrated a commitment to building the internal audit group by implementing a specialised graduate recruitment strategy,¹⁰⁸ recruiting additional technical and

¹⁰⁴ *ibid.*, 2040—*Policies and Procedures*.

¹⁰⁵ *ibid.*, 2300—*Performing the Engagement*.

¹⁰⁶ *ibid.*, 2400—*Communicating Results*.

¹⁰⁷ A co-sourced internal audit group is one in which a core set of in-house resources are used, and are supplemented, as necessary, by contracted-in expertise, typically on a audit task-basis. The role of CIA is typically retained in-house.

¹⁰⁸ In addition to the comprehensive graduate program offered to this organisation's generalist graduates, internal audit graduates receive intensive training in auditing which includes a targeted rotation to the financial management area within the organisation.

financial audit managers, strengthening the qualification base of audit staff and engaging consultants with appropriate professional qualifications.

The Chief Internal Auditor (CIA)

5.14 Both organisations with co-sourced solutions had internally appointed CIAs, who were permanent appointees and Senior Executive Service (SES) officers. This raised the profile of the internal audit groups by demonstrating executive management support for internal audit activities. These officers were not selected for their auditing experience, as their public sector experience and business knowledge were considered more important attributes. The senior managers interviewed during fieldwork confirmed that the CIAs had an important and positive profile within the organisations, which contributed to senior managers' willingness to implement internal audit recommendations, utilise internal audit services or seek internal audit advice.

5.15 In one of these organisations, the CIA was appointed following an external recruitment exercise. In the other organisation, the CIA was appointed from a pool of available senior operational managers, on a rotational basis. As potential appointees may not necessarily have audit experience and knowledge, the skills of the internal audit staff at the senior levels below the CIA needs to be sufficiently competent to support the CIA's assessment of the sufficiency of the AWP, resourcing needs and quality of products.

Other in-house audit staff

5.16 The other in-house internal audit staff in both organisations had a range of skills and experience relevant to auditing and/or the business environment, and were encouraged to be members of professional auditing and accounting associations. Both organisations supported the development of their internal audit staff with financial and study leave assistance. In addition, one of these organisations assisted internal audit staff in developing a sound understanding of the organisation's objectives and operations by providing internal training programs.

5.17 In one organisation, all internal audit staff (including the CIA) were members of the IIA, as well as being members of one or more other professional associations, such as the Information Systems Audit and Control Association (ISACA), and the Australasian Institute of Risk Management. Staff regularly attended technical sessions hosted by the IIA and ISACA. Some staff also attended the Public Sector Auditors Network Group, an informal network of auditors working in internal audit in the public sector.

5.18 In the other organisation, approximately half of the internal audit staff were members of the IIA and/or were members of the ICAA, or the Certified Practising Accountants in Australia (CPA Australia).

5.19 In both organisations, some internal audit staff had certifications from the abovementioned professional associations, and/or qualifications in accountancy or fraud investigations. Other audit staff were working towards obtaining these qualifications.

5.20 In both organisations, information on skills sets was maintained within personal development documentation. This information was updated periodically. The CIA and audit managers used their knowledge of internal audit staff skills to match audit staff competencies to audit tasks, and to identify development opportunities.

5.21 One of the internal audit groups could demonstrate that it maintained documentation in support of the ongoing analysis of staff development needs. This included the CIA analysing staff comments on each development course. These comments were used to assess the quality of development courses, as well as identify other development needs. The other internal audit group used the organisation's formal personal development system to identify and action staff development needs. All staff were assessed twice yearly in terms of their needs and the extent to which those needs have been met.

Contracted-in audit staff

5.22 In addition to the in-house internal audit staff, both organisations contracted-in resources from a panel of approved providers. Where in-house resources were not available, out-sourced resources were selected for individual tasks based on the out-sourced resource's cost-effectiveness, timeliness, quality, competence and relevant experience. In both organisations, in-house audit staff oversaw and reviewed the work of the out-sourced resource.

Out-sourced solutions

5.23 In the two audited organisations which had largely out-sourced internal audit activities, one had out-sourced the delivery of its AWP due to the limited availability of in-house audit staff. This organisation maintained the management and direction of internal audit in-house by appointing an internal CIA, and by developing the AWP internally. The out-sourced service provider had the ability to make suggestions on the content and adequacy of the AWP throughout the term of the contract (three years), and indicated a willingness to be flexible to this organisation's changing business and risk priorities. The CIA managed the contract with the out-sourced service provider, and had contract management experience. However, little

documentation was maintained to support discussions regarding the management of the contract, or changes to work priorities.¹⁰⁹

5.24 Two in-house staff assisted the CIA in this organisation. These staff were provided with professional development in risk management, control framework and auditing. This had been linked to their personal development programs.

5.25 The other organisation had recently out-sourced the development and delivery of a risk-based, three year strategic AWP to a service provider.¹¹⁰ This organisation had also out-sourced the position of the CIA to an engagement partner of the service provider, based on the relevance of the skills and experience of that officer. In addition to the delivery of the AWP, the service provider's role was to maintain appropriate internal audit policies, update the audit committee and internal audit charters, provide advice on risk management, corporate governance and the control environment, and provide secretariat support to the audit committee, including assisting with the evaluation of internal audit periodically.

5.26 The contract management business unit in this organisation managed the contract with the out-sourced service provider, with active oversight by the chair of the audit committee. The ANAO reviewed the request for tender documentation for this contract and noted that the assessment criteria for selection of the provider were both relevant and comprehensive.¹¹¹ In addition, the process undertaken, and documentation maintained in support of the assessment, supported the transparent selection of the preferred provider. In particular, this organisation was able to demonstrate the consideration of the relevant industry experience in its selection of a service provider, as well as the differences in staff level involvement between financial compliance and business improvement audits, by articulating resource requirements (skills and experience) to deal with the complexity of different audit tasks.

5.27 Both of the out-sourced service providers discussed above were professional accounting firms and, as such, the out-sourced service providers' audit staff were required to be members of professional auditing and accounting associations. Most of the service provider's audit staff (including the engagement partners) were members of either ICAA or CPA Australia, and

¹⁰⁹ Refer to Recommendation No.6.

¹¹⁰ Previously this organisation had contracted a provider to develop an annual risk-based AWP.

¹¹¹ These included: ability to deliver an effective product which represents value for money; demonstrated responsiveness to customer needs; the proposed audit management structure, staffing levels and their classifications, qualifications and experience; the proposed level of staff involvement in each auditable area (compliance versus performance); the level of supervision and quality assurance arrangements; overview on previous experience to similar organisations; an outline of the proposed audit methodology (including technology); and a director of the tenderer signing the tender submission. The organisation also assessed the timeliness of submission, and the quality of referee reports.

some were members of other professional associations, including ISACA, and IIA. Audit staff also had professional qualifications, and regularly attended technical sessions hosted by the ICAA, IIA and ISACA. Staff were also provided with ongoing learning and development opportunities, and supported to undertake relevant post-graduate qualifications.

Managing internal audit resources in audited organisations

Resource management

5.28 The ANAO examined the resource management practices of the internal audit groups for the 2003–2004 audit year.

Co-sourced solutions

In-house audit staff

5.29 For the two organisations with a co-sourced solution, the CIA was primarily responsible for managing the allocation of internal audit staff to audit tasks. The CIA employed several informal¹¹² and formal strategies to manage the continuous availability of skilled resources. One of these organisations demonstrated evidence of an annual workforce planning session, which established staffing needs, profiles and development requirements. Throughout the year, the CIA and internal audit manager(s) maintained and monitored worksheets, which showed the allocation of staff and budget against audit tasks. This organisation also utilised a leave calendar to track staff availability, including identification of training and development events. These activities and tools aided with the management of staff workloads, and in planning for future resource management decisions.

5.30 For the other organisation, the CIA and internal audit manager(s) reviewed the assignment of audit staff to tasks informally on an ongoing basis. The ANAO considers that internal audit groups, with in-house and/or co-sourced audit staff, may benefit from maintaining current information about audit staff work allocations and utilisations.

¹¹² By informal, the ANAO is referring to ad hoc and/or undocumented practices.

Recommendation No.6

5.31 The ANAO recommends that, in accordance with good record-keeping practices, internal audit groups maintain adequate documentation to support the transparency and objectivity of decisions made in relation to the development of the AWP, as well as resource management for the internal audit group.

Audited organisations' responses

5.32 All of the organisations agreed with the recommendation. Specific comments provided by IP Australia were as follows.

- IP Australia notes that it is important to ensure that the internal audit group is a cost effectively managed resource.

Contracted-in audit staff

5.33 In both of these organisations, when in-house staff were not available for an audit, or did not possess the required skills, the CIAs generally utilised contractors from the panel of approved providers. The CIAs examined the resumes of individual contractors to confirm that they possessed the necessary skills and experience to complete the required task. CIAs also managed the potential conflict of interest and independence issues when engaging panel members for specific audit tasks, through the inclusion of a suitable clause in the contract.

Out-sourced solutions

5.34 For the two organisations with out-sourced solutions, the engagement partners of out-sourced service providers were primarily responsible for managing the allocation of internal audit resources to audit tasks. The ability to provide adequate resources was first assessed during the tender evaluation process. During the audit year, the engagement partners reported on allocations to the CIAs. Similar to the organisations with co-sourced solutions, the engagement partners employed several strategies to manage the continuous availability of skilled resources. This typically involved assigning internal audit staff to tasks based on experience, and monitoring staff workload levels against the AWP targets.

5.35 In addition, both audit committees maintained regular contact with the out-sourced service provider regarding resources. However, only one could demonstrate discussion of this in audit committee meeting minutes.

Internal audit groups' practice management

5.36 The ANAO examined the adequacy of the policies and procedures developed, or made available, by the internal audit groups examined to guide their internal audit staff in delivering a quality audit product.

Guidelines for operation and audit work

5.37 Three of the audited organisations stated, in their internal audit charters, that the internal audit staff were to adhere to the professional auditing statements and standards,¹¹³ as well as the APS Values and Code of Conduct, and any other internal service or conduct standards. The other audited organisation listed these requirements within its internal audit manual. In addition, internal audit groups, generally, had additional procedures or guidance documented within their AWP, internal audit charters or business plans, which clarified some of their operational activities, control strategies and responsibilities.

5.38 The two organisations with co-sourced internal audit groups had developed an audit manual to guide staff in the practices and procedures of internal audit work. Both internal audit groups indicated that the manuals were out of date at the time of the audit.¹¹⁴ One of these was in the process of reviewing and updating the contents to reflect current governance, auditing, monitoring and communication requirements for internal audit. The other preferred to use the IIA Standards, rather than use internal audit resources in keeping the manual current.

5.39 One of the two organisations with out-sourced internal audit groups had received a copy of the out-sourced service provider's audit manual. This included internal policies and procedures for the operation of the internal audit group, as well as relevant technical and professional standards. The other organisation had not received a copy of its out-sourced service provider's audit manual, but had reviewed it during the tender evaluation process.

Application of guidelines to audit work

5.40 Three of the internal audit groups demonstrated that they had documented and, generally, applied a structured approach to undertaking audit work, including those audit tasks contracted out. However, one organisation had not documented its approach to managing contractors. A structured, documented approach to managing contractors allows both parties

¹¹³ Including those issued by the: ISACA; IIA; and Australian Auditing Standards Board.

¹¹⁴ Refer to Recommendation No.7.

to have a shared view of (and, hopefully, commitment to) the audit objectives, milestones and review procedures.

5.41 For the co-sourced solutions, the procedures for each audit task generally involved:

- a discussion between the selected contractor or in-house staff, and the CIA. This included documenting the key deliverables, performance milestones, and costs for the audit in an audit plan, as well as the audit objective, timeframe, scope, and reporting requirements;
- developing an audit test program based on the audit plan. The test programs were reviewed and agreed to by all parties. This is consistent with professional requirements;¹¹⁵
- the CIA writing to, or speaking with, the business unit to advise them of the upcoming audit and agree a timeframe. This included an information sheet on the audit process, the purpose and background to the audit, and any action required by the business unit;
- the audit staff or contractor commencing fieldwork, and providing up-dates to the CIA periodically. This included raising issues as they were being identified;
- senior audit staff performing an assessment of the quality and accuracy of the work. The CIA was also involved in this assessment;
- holding an exit discussion with the audited business unit to agree facts and recommendations; and
- issuing a draft audit report to the audited business unit for comment, incorporating the comments, and issuing a final audit report.

5.42 A similar process was undertaken for audits conducted by the out-sourced internal audit groups in the other two organisations audited. The primary difference was that the service providers' engagement partners performed the quality and accuracy reviews, with the assistance of the service providers' quality assurance divisions.

5.43 The ANAO also noted that one of the audited organisations, which used an out-sourced service provider, required both the senior managers and the audit committee to sign-off on the scope and objectives of the audit task prior to commencement. This assisted with obtaining management support, and clarified the scope and purpose of the audit early. It also avoided inefficiencies in the application of audit resources by identifying the required

¹¹⁵ IIA, *IIA Standards*, op.cit., 2240—*Engagement Work Plan*.

resources and confirming their availability. Documentation of this understanding is consistent with professional standards for internal auditing.¹¹⁶

5.44 All internal audit groups maintained official audit task files for each of the audits. During fieldwork, the ANAO reviewed a sample of official audit task files for the co-sourced internal audit groups, to observe evidence of the audit approach and documentation. These reviews generally confirmed that the internal audit groups applied each of the steps noted above when conducting audits, and generally maintained copies of planning information, correspondence, draft reports, review notes and final reports.

5.45 In all audited organisations, the ANAO found that the written responses from senior managers regarding the internal audit process and reports were generally positive, and all recommendations were agreed or agreed in principle. The ANAO was also able to confirm during interviews with senior managers that they were given an appropriate opportunity to provide feedback and comments to internal audit during planning discussions, exit interviews and the drafting of reports.

Quality assurance and review

5.46 The internal audit charters of three audited organisations, and the internal audit manual of the other audited organisation stated a requirement to conduct quality assurance and review. As noted above, organisations with an out-sourced service provider had the provider perform the quality and accuracy reviews, with the assistance of the providers' quality assurance division. For the co-sourced solutions, a mix of in-house and external officers (other contractors or the external audit committee member) conducted quality assurance and review activities.

5.47 Only one of the two co-sourced solutions had thoroughly documented the quality assurance process, and one of the two out-sourced service providers supplied documentation to support the robustness and adequacy of its processes.¹¹⁷ Broadly, for these two organisations, the quality assurance procedures covered:

- general procedures for assessing the adequacy of planning, risk assessments and audit scopes;
- conformity with applicable technical and professional standards, legislation and the approved audit program;

¹¹⁶ *ibid.*, 2200—*Engagement Planning*.

¹¹⁷ The ANAO notes that this service provider maintains ISO 9001:2000 certification.

- adequacy of supervision throughout the planning, examination, evaluation, report and follow-up process; and
- appropriate audit working paper standards.

5.48 For the co-sourced solution noted above, the ANAO also found evidence that the CIA examined the comments of the reviewer. This allowed the CIA to determine the quality of the audit, as well as assess the reviewer's ability to perform an adequate quality assessment.

5.49 The other two organisations audited did not have documentation available to support their internal audit group's quality assurance processes. However, one had received constructive comments from its external audit committee member, who periodically reviewed a selection of audits for completeness, clarity and compliance with professional auditing standards on quality control.¹¹⁸

5.50 The ANAO noted that two of the audited organisations had not undertaken all of the quality assurance activities as stated within their charters and/or internal audit manual.

5.51 The IIA Standards require internal audit's quality assurance program to include both internal and external assessments.¹¹⁹ Only one internal audit group had external assessments of its audits and audit practices.

Recommendation No.7

5.52 The ANAO recommends that internal audit groups of Commonwealth organisations provide complete and current practice management and professional guidance to their in-house internal audit staff. Guidance material should also clarify requirements for conducting internal and external quality assurance reviews.

Audited organisations' responses

5.53 All of the organisations agreed with the recommendation.

Communication of audit findings by internal audit

Reporting to the audit committee

5.54 The ANAO found that the internal audit groups in the audited organisations, had developed, and were periodically providing, several

¹¹⁸ Specifically Australian Auditing Standard 206, *Quality Control for Audit Work*.

¹¹⁹ IIA, *IIA Standards*, op.cit., 1312: *External Assessments*. This standard states that *external assessments, such as quality assurance reviews, should be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organisation.*

different progress reports to their audit committees. The progress reports provided information on the status of work against the approved AWP.

5.55 In two organisations, the progress reports took the form of a list of audits (which may or may not be a subset of the AWP), and their current status.

5.56 In another organisation, the reports listed audits and their status, as well as information on the budgeted versus actual timeframe and resources. The audit committee used this information to assess the adequacy of resources to achieve the stated objectives within the timeframe stipulated as part of the annual review of internal audit.

5.57 The other internal audit group had developed a series of AWP progress reports, which it presented to the audit committee at each meeting. The reports were concise, user-friendly, and were complemented with useful graphs. The data included:

- audits completed during the financial year;
- audits in progress, with distribution of audit time across: planning; fieldwork; reporting; and (estimated) time to completion. Actual time taken to complete the audit was then compared to the estimated total audit time from the individual audit plan; and
- completed audits, with distribution of time divided into three activity categories: planning; fieldwork; and reporting. These three categories also compared actual time taken to complete the audit with estimated time from the individual audit plan.

5.58 These reports are also used by the CIA to demonstrate the effectiveness of staff development, through improved group performance and the ability to complete audit work within the timeframes stipulated.

Audit committee reporting on its activities to the CEO

5.59 Two audit committees documented annual and/or quarterly reports to the CEO, with one recording the reports within its minutes. The other two audit committees provided verbal briefings. Three audit committees supplemented ongoing reporting with a documented annual report summarising its activities for the year.

5.60 Generally, the annual and/or quarterly reports did not explicitly discuss the work of internal or external audit, nor the work that was planned by senior managers to implement outstanding recommendations or issues arising from internal audit or Auditor-General reports.

Reporting to the CEO and executive management

5.61 In addition to the reports provided to the audit committee, all internal audit groups had access to their CEOs to discuss matters relevant to internal audit and the control environments within their organisations. Depending on the groups' specific responsibilities, they may also discuss risk management, fraud control and other governance issues.

5.62 Three of the internal audit groups also provided regular (either weekly, monthly or quarterly) reports and/or briefings to the executive management and senior managers about internal audit work and significant matters.

5.63 Reporting between internal audit, executive management and senior managers was more common in organisations with in-sourced internal audit solutions. However, one of the organisations with an out-sourced service provider was exploring how the provider could deliver reports to senior management on significant matters, other than those raised in internal audit reports, as this service was currently being provided through its corporate area.

Conclusion

5.64 The ANAO found that the internal audit groups examined were managing the timely delivery of their approved AWP. This involved the use of different resourcing solutions, and a mix of informal and formal resource management strategies. The need for skilled and experienced internal audit staff was also acknowledged as critical to the delivery of quality products, as was access to adequate practice management guidance, and/or professional standards and guidance. Internal audit groups were able to demonstrate that they generally adhered to guidelines, and had mechanisms in place to monitor compliance with standards.

5.65 The ANAO considered that opportunities existed for some organisations to improve the transparency and management of their resource and practice management processes, by maintaining more comprehensive documentation. In addition, the ANAO found that current and complete practice management and/or professional guidance was not always available for internal audit staff.

5.66 The ANAO found that the reporting and briefings undertaken by internal audit had assisted in keeping executive management informed of the internal audit groups' activities and issues in a timely manner.

6. Evaluating Internal Audit

This Chapter of the report explains the importance of, and suggests some key criteria for, the periodic evaluation of internal audit. The evaluation of the internal audit group is necessary in order to objectively assess the ongoing relevance of its work program and effectiveness in delivering its products and services.

Introduction

6.1 The investment of resources in an internal audit group can be significant, and will be judged against the value it returns to the organisation. Therefore, organisations should periodically scrutinise and evaluate the value achieved from, and performance of, their internal audit groups to:

- measure the timeliness, quality and cost-effectiveness of their products and services ; as well as
- confirm their objectivity, competence and alignment with organisational goals.

6.2 In order to perform this evaluation objectively, audit committees need to establish categories of key performance measures with their internal audit groups, which deal with resource management, relationship management, product and process quality, and product impact. Documentation should be maintained, to clearly demonstrate the objective evaluation of the effectiveness and efficiency of internal audit to the CEO.

6.3 The Federal Government has emphasised performance information as an integral part of its public management reforms, and an important element of any robust corporate governance framework. The move to an accrual-based outcomes/outputs framework was designed to ensure the following focus:

Resource management, with a focus on measuring performance, in terms of what is being produced, what is being achieved, and what is the cost of individual goods and services.¹²⁰

¹²⁰ Department of Finance and Administration, *Review of Budget Estimates Production Arrangements*, July 1999. Also referred to as 'The Vertigan Report.'

Better practice principles and professional guidance

6.4 In accordance with better practice guidance¹²¹ and professional auditing standards,¹²² the performance of internal audit should be assessed to confirm that it meets its objectives in an effective and efficient manner. This evaluation should be made against performance measures agreed with the audit committee, as documented in the internal audit charter and/or internal audit business plan. The evaluation may also assess performance against peers, as well as audit staff's compliance with professional standards.

Evaluation of internal audit in audited organisations

6.5 All audited organisations had documented a set of performance measures for internal audit.

6.6 The two organisations with co-sourced internal audit solutions¹²³ had documented these measures in their business plans. One of these internal audit groups had included measures to assess its effectiveness in making resourcing allocations, and its ability to support the organisation in discharging its governance and accountability requirements. It could demonstrate that it reported annually to the audit committee against the achievement of some of its measures, but not all of them. However, its progress and annual reports did not include detailed internal audit management information (for example, cost and staff utilisation), making it difficult for the audit committee to assess the adequacy of resources to achieve the stated objectives.

6.7 In the organisations with out-sourced internal audit solutions, the performance measures had been documented within the internal audit charters. In one organisation, these reflected the measures noted in *The Internal Audit Guide*.¹²⁴ However, the organisation did not report against these at the time of the audit.

6.8 In the other organisation, a new out-sourced service provider had recently been engaged, and some high-level measures had been documented. These would be applied later in the year, and clarified through the development of evaluation criteria, which would capture information critical to the evaluation of the group.

¹²¹ ANAO, *The Internal Audit Guide*, op.cit., p.43.

¹²² IIA, *IIA Standards*, op.cit., 1300–Quality Assurance and Improvement Program.

¹²³ Refer to p.64 for a detailed discussion of the organisations' staffing structures.

¹²⁴ ANAO, *The Internal Audit Guide*, op.cit.

6.9 None of the organisations audited had established targets for the performance measures.

6.10 The ANAO also noted that all internal audit groups gathered informal feedback on client satisfaction with their products and services, typically during the AWP development process and audit reporting processes. Only one internal audit group used a client satisfaction survey, which was a new approach for the organisation and, at the time of this audit, was being assessed for its ability to provide constructive feedback. The CIA was also considering other methods to obtain objective and balanced feedback on the value of the internal audit group's work. Another organisation indicated its intention to develop a client satisfaction survey, but had yet to commence this process.

6.11 Overall, the ANAO considered that performance measures and evaluation of internal audit groups were areas where organisations could find opportunities for improvements.¹²⁵ In addition to performance measures regarding the cost and timeframe for audit products, the ANAO considered that the audit committees should assess and monitor the adequacy of the:

- internal audit resourcing structures and budgets to achieve the groups' stated objectives;
- focus for internal audit activities (topic selection and mix) based on the organisations' assessed risk exposures and adequacy of their control frameworks; and
- value achieved from the groups by way of improved compliance and/or performance.

6.12 There was no commentary within the audited organisations' audit committee reports of costing alternative structures, nor was there documentation confirming the cost efficiency or value of the services provided.

6.13 The ANAO also refers organisations to professional accounting and auditing bodies for guidance on how audit committees can evaluate internal audit. Audit committees could also refer to the guidance provided in the ANAO's Better Practice Guide entitled *Better Practice in Annual Performance Reporting*.¹²⁶

¹²⁵ This observation is similar to the finding in the ANAO's most recent control structures report, where it was found that *only nine of the 21 entities...have formal procedures in place to assess whether the internal audit function delivers an effective, efficient, and value for money service*. Refer ANAO Audit Report No.67 2001–2002, op.cit., p.43.

¹²⁶ ANAO, Better Practice Guide, *Better Practice in Annual Performance Reporting*, Canberra, April 2004. Available: <www.anao.gov.au>.

Recommendation No.8

6.14 The ANAO recommends that internal audit groups establish, document and use performance measures, which would facilitate the objective and transparent evaluation of the group and its audit products. Performance measures should be periodically reviewed to confirm their ability to provide useful information on audit resource management, relationship management, product and process quality, and product impact.

Audited organisations' responses

6.15 All of the organisations agreed with the recommendation. Specific comments provided by DEWR were as follows.

- DEWR agrees with the recommendation. It would also be useful for the ANAO to provide internal audit groups with additional guidance regarding the methodologies that could be used to measure value of services provided by internal audit groups by way of improved compliance and/or performance.

Conclusion

6.16 The ANAO found that internal audit groups had articulated outputs and activities within their business plans and/or charters, and had developed some performance measures to monitor progress towards achieving these. However, the ANAO considers that organisations could further develop their performance measures, particularly in the areas of product quality and impact.

Canberra ACT
23 July 2004



P. J. Barrett
Auditor-General

Appendix

Appendix 1: Organisation comments

The comments provided by each of the audited organisations in response to the audit report are shown below.

Department of Health and Ageing

The Department is in general agreement with the thrust of the report and its recommendations.

Department of Employment and Workplace Relations

DEWR volunteered to be a participant in this audit as DEWR considers internal audit and the audit committee play a key role in strengthening the governance framework of its organisation through independent assurance and advice to the department's executive.

DEWR welcomes the better practice focus of the recommendations contained in the report.

Comcare Australia

Comcare supports the recommendations in the report, while noting that many of them do not relate to us. We have been reassured through the ANAO audit process that the approach we have adopted in managing the internal audit function as part of our overall governance arrangements is sound. The importance of the audit in providing a benchmark to better practice, and ultimately improved organisational outcomes, is appreciated.

IP Australia

It has been helpful to get a comparative perspective on how some internal audit areas in other government organisations operate. The recommendations of the ANAO report on "Business Support Audit—Management of Internal Audit in Commonwealth Organisations" are supported. The recommendations of the report and the comparative assessments of internal audit, and committee charters, will provide a useful background for improving the operations of the internal audit function and the audit committee at the local level.

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