

Institute of Internal Auditors, Annual  
Directors' Forum, Canberra

**Internal Audit:  
The Auditor-General's  
Perspective**

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## INTRODUCTION

Thank you for inviting me to speak to your 1995 Forum. When I received this invitation from the Institute of Internal Auditors, I noted with interest that the theme emphasised the contribution which Internal Audit can make in the changing environment.

The ANAO has the strong view that internal audit is an integral part of an organisations internal control structure and has long been highly supportive of the need for a viable and effective internal audit function in the public sector.

I have personally been involved with the internal audit function in a number of organisations over many years. When I was at the Department of Finance, not only was I involved in the departments ongoing commitment to the effective operation of internal audit in the APS, but I also chaired the Departments Audit Committee and was a member of the Audit Committee for both the Commonwealth Superannuation and Public Sector Superannuation Schemes (CSS and PSS). My interest has even more direct relevance now that I am Auditor-General (and chair of the ANAO Audit Committee).

I look forward with anticipation, and a high degree of self-interest, to hearing your views as Directors of Internal Audit on how you are going to make a positive contribution in the changing Australian Public Service (APS) environment. This will be instructive for Audit Committees as well as for agency management. To be frank, I had in mind those audiences as well in developing my presentation for today.

This Forum is yet another indication to me that the Institute is continuing its commitment to ensure that internal audit plays a positive role in today's dynamic public sector environment.

Following some background comments on developments in internal auditing in recent years, I will provide perspectives on four areas which I regard as important to you as follows:

- (1) your contribution as agents for change in regard to relevant Public Service Reforms;
- (2) your management of the internal audit function;
- (3) the need for a better understanding of the nature, scope and quality of internal audit work generally; and
- (4) the need to add value to public administration and to assess your performance.

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I will finish with some brief concluding remarks.

## BACKGROUND

Over the past decade the public sector has undergone an extensive program of public sector reforms which have had the overriding themes of improving performance and accountability. Against the background of reform and other initiatives being taken in the public sector, internal audit groups in agencies should have been aligning their philosophies and approaches to fit into and facilitate the many changes which have been taking place.

In this context, the ANAO undertook a three stage review of internal audit within the public sector in the period 1989 to 1993. This review was in response to the Joint Committee of Public Accounts (JCPA) recommendation in 1989 that:

The Australian Audit Office undertake an efficiency audit of internal audit in the Commonwealth sector. The efficiency audit should include a comprehensive survey of internal audit. The Auditor General: Ally of the People and Parliament, Joint Committee of Public Accounts,

Report No 296, AGPS, Canberra 1989 (Page 206).

The first stage surveyed the performance and management perceptions of internal audit and revealed that although internal audit was well established in the Commonwealth public sector and enjoyed the support of management, it did not always provide management with relevant and appropriate advice.

The second stage involved an efficiency audit of internal audit in eight Commonwealth organisations which identified specific policies, procedures and practices necessary for improving the efficiency and effectiveness of internal audit.

These findings culminated in the publication, in March 1993, of *A Practical Guide to Public Sector Internal Auditing* *A Practical Guide to Public Sector Internal Auditing: Australian National Audit Office, AGPS Canberra, 1993*. This Guide not only assists internal auditors at an operational level but also gives audit committees and departmental executives a better appreciation of the range of services internal auditors can offer, as well as providing useful guidance and standards of best practice on how to get best value for money from internal audit.

In March 1994, the JCPA broadly reviewed the second stage of the efficiency audit and, in particular, the usefulness of the Guide. Review of Auditor-General's Reports May 1991 - September 1992 JCPA Report No 330, AGPS Canberra, March 1994, (Pages 121 to 132). The response to the Committees survey of user reaction to the Guide was very supportive as indeed were the Committees comments. However, the Committee was concerned that, in relation to the Guide:

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its value is only realised if it is used by managers and auditors in Commonwealth organisations. Ibid, (Page 122).

In this respect the JCPA recommended that the Department of Finance should take a broader and more active role in improving internal audit standards in Commonwealth agencies by developing better in-house knowledge and expertise in internal audit and related activities. Finance argued that the fundamental goal of improving internal audit standards in Commonwealth agencies was largely being met at that time. Of relevance to this address is Finances Circular 1993/5 of 22 February 1993, which stressed the importance of internal audit as a key management tool and encouraged the establishment of Audit Committees within agencies (see paras 1.8.1 to 1.8.4).

Although I have been asked to provide my perspectives of internal audit as Auditor-General, I should also mention my view as a Chief Executive and chair of the ANAO Audit Committee. In 1989 the ANAO survey found that a gap existed between service levels expected of internal audit by management and the service provided. After lunch, we will have the opportunity to hear from Mr Clive Mathews, co-author of *A Profile of Internal Audit in Australia 1995* *A Profile of Internal Audit in Australia 1995, Clive M H Matthews, Barry J Cooper and Philomena Leung. Deloitte Touche Tohmatsu/RMIT Accountancy, Melbourne 1995.* In his book, the expectation gap is identified as a major issue which must be addressed by the internal audit profession. I should perhaps observe that Mr Mathews is probably correct, at least in relation to the public sector that, despite the various efforts made to establish the credibility of the internal audit function over many years, much more still remains to be done.

I will therefore only briefly outline my view of internal audit as a Chief Executive as follows:

- (a) to assist (but by no means alone) in providing an assurance that the organisation has assessed its financial and operational risks and has strategies, structures and controls in place to manage effectively these risks;
- (b) to be a valuable source of independent (i.e. independent from line management) advice about any aspect of the organisations performance;
- (c) to be a source of advice and assistance about what is around the corner and how best to meet and take advantage of whatever that might be (in passing, I would suggest to you that this is an area where internal audit (and the ANAO) could do much more than it is currently doing); and
- (d) to assist in ensuring relations with our external auditors is productive, complementary and professional.

In short, I have long asserted that internal audit should be management's right hand.

I now turn to my perspectives of internal audit as Auditor-General.

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## CONTRIBUTING TO PUBLIC SERVICE REFORMS - AS AN AGENT FOR CHANGE

Internal audit, as well as the ANAO, and other review mechanisms is well placed to make a significant contribution to the development and implementation of a range of public sector reforms. It therefore carries a responsibility to maintain a working understanding of the whole of the public sector reform agenda. Internal audit must also recognise that public sector reforms apply equally to the internal audit function as they do to the agency as a whole.

In setting priorities for reform, the directions set by MAB/MIAC in the various publications such as Building a Better Public Service Building a Better Public Service, a joint MAB/MIAC publication, No. 12 1993 and Ongoing Reform in the Australian Public Service Ongoing Reform in the Australian Public Service, An Occasional Report to the Prime Minister by MAB, No. 15, October 1994 must be taken into account. You will recall that the major themes identified in Building a Better Public Service are:

- Making performance count: by looking closely at client needs and service quality, evaluating achievements, rewarding good performance at all levels, learning from and building on past performance, and being accountable;
- Leadership: emphasising the key responsibilities of agency heads in managing for results, and clarifying the roles of central agencies and other mechanisms for sharing knowledge and experience; and
- Strengthening the culture of continuous improvement: through better people management and development, and by embedding attitudes in a culture that equivocally seeks to find better ways to achieve desired results. Ibid, (Page 13).

I suggest to you that internal audit must, and be seen to, apply these elements of the ongoing reform program within its own functional responsibilities, as well as reflecting these themes in the audits that it undertakes. This may well take many out of their traditional comfort zone but it is the only way to ensure that the function remains relevant to management.

Internal audit is a management function which, at a minimum, monitors the continuing effectiveness of internal control systems and legal compliance. No one doubts the importance of such assurance. In fulfilling this role the internal auditor has an excellent viewpoint from which to recognise opportunities for strengthening systems and procedures, for improving methods and for achieving greater efficiency, all with the object of increasing the contribution management can make towards achieving the organisations corporate objectives. This clearly goes beyond simply providing the traditional assurance of the green tick. For instance, it has taken some internal auditors much more into the framework of evaluation as a performance/accountability tool as I will discuss later.

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There is an increasing focus on corporate governance and internal control issues. This is heightened by the adoption of more commercially-oriented approaches and practices in many agencies, a greater focus on quality client service and the increasing provision of such services by the private sector. Market testing and outsourcing are now endemic to the management process. Among other things, we will need to be more professional in developing and managing contracts. As well, we will need to manage, as well as report, on an accrual basis. It is highly likely that most agencies will adopt accrual accounting and decision support systems based on accrual data. Management will be looking for advice on the implementation and oversight of such developments from the internal audit team. This will be particularly so after the financial legislation replacing the Audit Act is passed which makes the Chief Executive legally accountable for the management of the organisations resources.

I recently attended a conference of International Organisation of Supreme Audit Institutions (INTOSAI) of which the ANAO is a Governing Board member. This is an area where the ANAO adds value in the context of our responsibilities and obligations as part of the wider international group of national audit offices. One of the areas in which the ANAO has made a significant contribution is through the development of standards as Chair of the Auditing Standards Committee. INTOSAI, through the Auditing Standards Committee has recently decided to develop a code of ethics. I am aware the International Institute of Internal Auditors already has such a code and I am sure the Committee would benefit greatly from working closely with the Institute on this project both in Australia and overseas. In fact I have such a commitment from Bill Taylor, Chairman of the Board of the Institute of Internal Auditors. You are probably aware that Bill is also Auditor General of the Inter-American Development Bank.

## **Managing Risk**

Risk management is an important, and one could say a pervasive, element underlying many of the reforms which have taken place in the public sector. Unfortunately, there has been a perception that auditors have inhibited the development of risk management

approaches by being unduly critical of initiatives taken and mistakes made. The Australian Public Service Reformed - An Evaluation of a decade of Management Reform - Task Force on Management Improvement. AGPS, Canberra, December 1992 (Page 101). Managing Risk - Guidelines for Managing Risk in the Australian Public Service, Exposure Draft MAB/MIAC Report No 17, AGPS, Canberra, July 1995 (Pages 10 and 11). To the contrary, ANAO is a strong supporter of the concept of risk management for the following reasons:

- Managing risk is an essential element of good management practice, particularly in today's climate of increasing financial constraint, greater competitiveness and contestability for both advice and services. The overriding aim of both internal and external audit is to improve public administration and the accountability framework through which our performance will largely be judged. Managing risk efficiently and effectively reflects one concrete way in which this can be achieved. It is

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necessary to manage risk on an ongoing basis at all levels of our organisations. This requires clear guidelines and a sound awareness/education program.

- The concept of risk management is fundamental to both internal and external auditing. When undertaking audits, professional auditing standards require the auditor to first identify, and then assess the risks which exist in the organisation. In this way, resources can be applied to those areas of greatest risk.

The lesson to be learnt from experience to date is that auditors have to be upfront about such attitudes to combat inaccurate perceptions arising from critical comment in audit reports. There is always an issue of balance in such reports as I have discussed elsewhere. Accountability: Balancing Internal Control and External Review - The Auditor-General's Perspective. Address to the Lunchtime Seminar Series for Senior Officers, Sydney, 23 August 1995.

On the performance audit side, the ANAO has in place planning practices which help identify a range of risks in public sector entities. In this way, our resources can again be focused on areas of greatest risk to identified performance in achieving the required results.

At the same time, the ANAO has a range of basic safeguards in place which help ensure that we are not exposed to unnecessary risks. These include, for example, the risk of issuing an incorrect audit opinion, or a performance report which lacks sufficient supporting evidence. These risks are highlighted in audits which are contracted out. As in other areas of the public service, we simply have to be more proficient in managing such contracts and in encouraging staff to be involved in the outsourced services as an important element of their personal professional development.

It would seem apparent that internal audit should adopt a risk based strategic planning approach linking risk analysis with the organisations key objectives to ensure that internal audit coverage is aligned with the organisations overall business strategy. This is of course no easy task and requires both internal audit and management being committed to maximising the benefits from a viable and effective internal audit function. I note the following view expressed by the Institute of Internal Auditors - Australia (IIA), Canberra Branch in their Position Statement on Managing Risk:

The view of the Institute of Internal Auditors - Australia is that failure to apply the new internal control requirements while implementing the new management structures, tools and techniques would lead to exposure to unacceptable risk. Position Statement on Managing Risk in the Australian Public Service, The Institute of Internal

Auditors - Australia, Canberra Branch, April 1995 (Page ii).

When speaking at the Canberra launch of the MAB/MIAC Guidelines for Managing Risk, referred to earlier, I drew attention to what I considered to be a particularly

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pertinent insight of the IIA in relation to the following internal requirements to achieve results with acceptable risks:

- values and behaviours support, honesty and integrity (ETHICS);
- competent, committed people are held accountable for results and systems (PEOPLE); and
- systems exist for cost-effective control of key result areas and risks (SYSTEMS).

I would therefore suggest that internal audit should:

- have full and unfettered access to the organisations strategies and plans;
- use the strategies and plans as the basis for the internal audit plan, extracting major themes and issues to provide a focus for internal audit activity; and
- refine internal audits strategy and plan in consultation with management and the Audit Committee.

In addition, it would be highly desirable for internal audit to be able to relate the outcomes of their audit findings to the assessed risks of the various elements of their agency's functions or business. This would be of considerable assistance to strategic management of the agency in my view as well as putting any action on the audit findings well and truly in management's court.

## **Ethical Conduct**

In June 1993 MAB published a new enhanced set of key public service values which the Government adopted as the foundation for a new and much less prescriptive Public Service Act. The traditional values of probity, integrity and conduct have been expanded and complemented by a recognition of responsiveness to governments, a close focus on results, a strong commitment to accountability, and continuous improvement through teams and individuals.

On 27 July 1995, Dr M S Keating, AO, in his presentation on Public Service Values as part of the 1995 Peter Wilenski Memorial Lectures, stated that:

The first duty of public servants is to conform with all legal requirements and the spirit of those requirements. Public Service Values, Dr M S Keating, AO, 1995 Peter Wilenski Memorial Lectures, Canberra, 27 July 1995 (page 7).



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He also added that:

the lead from the top is important in setting an example and establishing the ethical tone in any organisation. Ibid (page 11).

Internal audit has an important role to play in applying these values when assessing the internal control environment. If such values are not applied consistently, then even the most perfect system of internal control can be compromised.

I view internal audit as a barometer on the ethical standards of an organisation.

## MANAGEMENT OF THE INTERNAL AUDIT FUNCTION

There is a high correlation between the contribution which internal audit can make to public sector reforms and the management of the internal audit function. In this context I have extracted the following competencies from the draft statement of competencies contained in the NSW Treasury publication *Statement of Best Practice - Internal Control and Internal Audit* *Statement of Best Practice - Internal Control and Internal Audit, NSW Treasury, Sydney, June 1995 (Appendix I)*. which seem to me to encapsulate the expectations of management in the changing public service environment:

Directors of Internal Audit should:

- contribute to the successful achievement of the organisations objectives and to the development and implementation of new organisational strategies;
- provide the best advice using internal audits knowledge base and experience to enable management to make the best decisions and improve their performance;
- identify issues beyond the focus of specific assignments and provide appropriate solutions;
- add value to the organisation and create continuous improvement in deliverables and work practices;
- demonstrate extremely high professional standards, be receptive to new ideas and see change as a permanent, perpetual process;
- contribute to the development of staff through on the job training, coaching, training programs and the like;

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- identify, evaluate and resolve issues affecting both management and professional risk and plan accordingly to minimise such risks;
- ensure that quality of the audit product meets or exceeds professional standards by regular quality assurance reviews; and
- demonstrate a high level of current technical skills and expertise and be proactive in assessing the impact of current and forthcoming technical pronouncements on management.

In short, the Director of Internal Audit can and should play a key role in an organisation and strongly influence the direction of that organisation with the quality of advice provided to management. The Director of Internal Audit also carries full responsibility for the success of the internal audit function. As in any devolved authority relationship, the Director has to have both the power and flexibility to act in accordance with those interests.

Long gone are the days, if they ever existed, where the Internal Audit Director spent most of his or her time preparing intricate and detailed strategic and tactical audit work plans! I hasten to add that such plans are essential to facilitate planning both within and outside the organisation but stress there are now other imperatives which also need to be addressed.

## **Establishing a Complementary Relationship with the External Auditor**

The establishment of a co-operative and productive relationship between ANAO and internal audit ranks highly on my list of expectations. Such a relationship is important because of the similarities in the nature and scope of activities we perform in the public sector.

There are also clear responsibilities which internal audit and the ANAO share in order to understand the organisations business and the manner in which it operates, such as maintaining a comprehensive understanding of the organisations risks and its control systems. In this regard, significant efficiencies can be achieved if external auditors are able to rely upon the scope and quality of internal audit work and vice versa. In this way ANAO can build on rather than duplicate the important work that internal audit does. Quality assurance on both sides is essential.

The co-ordination of such work is governed by the separate roles and responsibilities of internal and external auditors. Internal audit provides a service to management while external audit provides a service to the Parliament as well as to Ministers, Boards and management. To me, this simply means that both parties need to establish an environment which promotes open consultation and dialogue and ensures that all parties are aware of their respective responsibilities. We should both adhere to a policy of no surprises to the maximum possible extent.

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Since it is management's prerogative to determine the scope and focus of internal audit activity, it is also open to them to involve internal audit more heavily in work relevant to the external audit function. A good example of utilising a co-ordinated approach is in the audit of financial statements. Such an approach can assist in maximising the efficiency of the combined audit effort and minimises the combined audit risk. Such arrangements are also beneficial in facilitating timely finalisation of financial statements to achieve reporting deadlines. This will also be important for the new generic audits of Financial Controls and Administration which will leverage off the financial statement audits to a large extent.

In another context, Op. cit., *Balancing Internal Control and External Review* (page 8). I mentioned the ANAO's experience with a one audit approach in relation to the Commonwealth Bank audit. The purpose of the arrangement was to maximise resource efficiency, deliver effective internal and external audit services and minimise disruption to the client. At the strategic planning stage, managers from internal and external audit jointly determine the risks, timing, scope and audit strategy for each auditable area of the Bank.

Prior to entering into a partnership relationship regarding the co-ordination of audit coverage, the ANAO will complete a preliminary assessment of the adequacy and effectiveness of internal audit performance. If satisfactory, arrangements can then be made to cover such matters as:

- timing, planning and scheduling of audit work;
- audit coverage, test levels and sample selection;
- review and reporting procedures; and
- attendance at audit committee meetings on a regular basis.

At times, the ANAO is asked why it needs to evaluate the work of internal audit. The reasons are quite straight forward. First, our professional standards dictate that it is required. But the main reason is that it is the ANAO (as the external auditor), which puts its name to the audit report. As indicated in the Statement of Auditing Practice issued by the Australian Accounting Research Foundation (AUP 2):

The report of the external auditor is his/her role responsibility and that responsibility is not reduced by any use made of the internal auditors work.

In other words, the buck stops with us. We cannot look for other scapegoats. Nor would we wish to do so. Greater reliance requires greater assurance.

Another way in which we can co-operate for our mutual benefit is to utilise, where circumstances permit, the involvement of internal audit in ANAO audit teams.

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Although such an arrangement is not always possible, or even necessarily desirable, it is one which should be considered on a case by case basis.

## Responding to Audit Committees

The ANAO has long been a strong advocate of the need for Audit Committees in public sector agencies. It is pleasing to note that in fact most agencies have in place an audit committee to oversee and direct the work of internal audit thus, potentially at least, increasing its effectiveness and value to the organisation. As you are all aware the establishment and maintenance of audit committees will be a legislative requirement under the pending Financial Management Accountability (FMA) and Commonwealth Authorities and Companies (CAC) Bills.

The minimum functions and responsibilities of an audit committee as set out in the draft Finance Ministers Orders (FMOs) under the FMA Bill, which have been circulated by the Department of Finance, must include at least:

- the approval of strategic audit plans for the operations of the agency to be reviewed or examined by internal auditors;
- 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 all matters raised in a report of the internal auditors or in a report of the Auditor-General concerning the agency;
- as far as practicable, the co-ordination of audit programs conducted by internal auditors and the programs conducted by the Auditor-General; and
- the review of financial statements, before their submission to the Chief Executive for approval, to ensure that the statements are prepared in accordance with these FMOs.

The CAC Bill specifies that an Audit Committees functions should include:

- helping the organisation and its directors to comply with obligations under the legislation; and
- providing a forum for communication between the directors, the senior managers of the organisation and the internal and external auditors of the organisation.

It is important that internal audit develop and maintain a close working relationship with the agency's Audit Committee. In this respect, meetings with internal audit

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should be held regularly and the Audit Committee fully involved with setting directions and priorities for the function.

As internal auditors, you should capitalise on your in-depth knowledge of your organisation and on the services you can deliver, including:

- identification of areas of high risk;
- identification of areas of poor performance in relation to programs and management; and
- the provision of technical support from the wide range of skills available.

In turn, audit committees can ensure the proper functioning of internal audit by:

- preserving the independence of the internal audit function;
- approving the internal audit charter and ensuring that internal audit resources are not diverted to non-audit duties; (a tempting option in this day and age of scarce resources);
- ensuring adequate resourcing of the internal audit function. (ANAO reviews have identified lack of staff, limited audit experience and lack of training as contributing factors to low levels of audit coverage);
- reviewing the extent to which internal audit recommendations are implemented and that appropriate timely action is taken on audit findings;
- maximising the degree of co-operation between internal audit and management;
- monitoring the performance of internal audit against agreed performance criteria (on an on-going basis);
- monitoring the extent of reliance on internal audit work by the external auditor; and
- reviewing developments in the field of internal audit.

Members of Audit Committees should, ideally, respect the contribution which internal audit makes. Internal audit should not, however, assume that such respect automatically comes with the territory - it must be earned by internal audit through its performance. That is just another illustration of the focus on results and the need to show that we are adding real value to public management.

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## **Relating to Program and other Evaluations and Reviews**

As with the external audit function, there are a number of similarities between internal audit and program and other evaluations. These have led to some agencies including both functions in one organisational unit and, in some instances, assigning responsibility for the conduct of evaluations to internal audit.

In my view, this latter approach is not the preferred one. A key element of program evaluations is that they be owned by program managers. While the involvement of independent parties in evaluations is important, in my view, this should not extend to them being conducted by people exclusive of program management with the results literally being imposed on the latter.

Where organisations have established a separate evaluation function, internal audit should co-ordinate its activities and liaise with that function so as to make the best use of the evaluation work, thus avoiding duplication of effort. Internal audit and management should be alert at all times to the benefits of including internal audit staff in the team responsible for the conduct of program evaluation. Not only is there likely to be valuable skills transfer, there is also a learning process for the auditors about the organisations functions and the way in which it conducts its business.

## **Supporting the Control of Fraud**

As the audience here today would be aware, APS agencies have been required to prepare Fraud Control Plans on an on-going basis. This would be a legislative requirement under the proposed FMA Act (Clause 46). While it can often make sense for responsibility for fraud control and internal audit to also be included in one organisational unit, I also suggest that the functions should remain separate ones.

Where an organisation has established a separate fraud control function, internal audit should also co-ordinate its activities and liaise with the fraud control function to assist management in minimising the organisations exposure to fraud. Not surprisingly, this is an area of considerable concern to the Parliament and one on which there has been extensive comment and attention.

As a matter of course, internal audit should ensure that its work plan includes an evaluation of the organisations compliance with the Commonwealths Fraud Control Policy. This should be an important source for commenting on performance in the organisations annual report. You would be aware that the main focus of fraud control plans is on prevention which largely means having robust systems in place which both discourage and detect any fraud.

## **Funding Arrangements**

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In the current climate of user pays, I am aware that some organisations are attracted to the proposition that internal audit be a self funded activity. Such an arrangement would involve internal audit undertaking audits on a user pays basis.

While I am a strong supporter of user pays in the right circumstances, I see real dangers in applying the concept to the internal audit function, particularly if the client can largely dictate the work program. One could envisage an outcome where a low risk program with sufficient resources could be subject to internal audit coverage while a high risk area with few resources would not be subject to any coverage. Such an outcome would not benefit any party in my view. Agencies need to have independent and objective advice from a professional internal audit resource even if it has to be shared.

I am in favour of the cost of internal audit being regarded as a corporate obligation. In this way the coverage of all auditable areas is not dependent on the capacity to pay and the independence of internal audit is preserved. The costs of internal audit can, and often should, be allocated on an agreed basis across cost centres. This approach can be a useful discipline as it will assist managers to evaluate the service provided.

## **Outsourcing of Internal Audit Services**

I note that my colleague Mick Roche is going to cover this issue later this morning. From an external audit point of view, outsourcing of internal audit is viewed as another means of service delivery. In other words, the ANAO neither supports nor opposes outsourcing of the function per se. In essence, the decision depends very much on just what kind of internal audit service agency management requires. I am particularly sympathetic to the situation confronting management in determining viable arrangements in small agencies. Any decision by management on outsourcing should, however, be made on a realistic assessment of value for money. This will vary with the circumstances of each agency and the trade-offs individual management's are prepared to consider.

There are potential advantages and pitfalls in any outsourcing arrangement. The only observation I would make is that the key to any outsourcing arrangement is the need to retain the capacity to manage effectively the service provider. It should not just be assumed the service will be provided as agreed; there needs to be a suitable level of monitoring and review to ensure this is in fact the case.

## **DEFINING THE NATURE, SCOPE AND QUALITY OF INTERNAL AUDIT WORK**

The traditional role of internal audit has been to provide assurance to management that there is satisfactory compliance with the organisations financial controls. Best practice now views internal control as being inextricably linked with all the management processes, techniques and tools employed by an organisation to achieve its strategic objectives. These cover a whole plethora of aspects including:

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- the identification of risks with potential to affect the achievement of an organisations objectives;
- controls established by management to mitigate identified risks; and
- the measurement of performance, both financial and operational.

I suggest to you that internal audit must shift, or have the capability to shift, beyond its traditional role and embrace a much wider perspective by assisting management with the maintenance of an effective system of internal control throughout the organisation, and reviewing the efficiency and effectiveness of it, rather than just providing restricted assurance on financial and related controls. Both internal audit and management, through the Audit Committee, should assess carefully the benefits of internal audit covering the whole audit continuum and focus its attention on the organisations key activities. This will assist agencies to achieve the objectives of the Governments financial and broader resource management reforms.

Both the ANAO and internal audit are well placed to implement benchmarking best practice to help assess an organisations performance, particularly on key management processes, by sharing performance indicators developed during performance audits. This will necessitate the establishment of a common pool of performance indicators possibly using the Internet and/or the Commonwealth managers toolbox.

On the matter of benchmarking. I would like to draw your attention to the MAB/MIAC pamphlet *Benchmarking: Improving Performance in the APS* which was released recently on the first stage of its five phase benchmarking project. The proposed MAB/MIAC framework should assist interested agencies to work together, reducing duplication and barriers to sharing best practice and good ideas. Such a framework would be useful, inter alia, in developing more robust and credible internal control mechanisms across the public sector.

The United States Committee of Sponsoring Organisations of the Treadway Commission (COSO) report *Internal Control-Integrated Framework*, Committee of Sponsoring Organisations of the Treadway Commission (COSO). (Comprising four volumes. Executive Summary, Framework, Reporting to External Parties and Evaluation Tools), New Jersey 1992. reinforces and re-emphasises the proactive role of internal auditors in establishing and maintaining an adequate, effective, and efficient internal control system.

The role of internal auditors, according to the provisions of the COSO report, is to assist and participate with management in:

- defining internal control and related objectives;
- establishing internal control and its components;



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- determining appropriate evaluation tools in measuring adequacy and effectiveness of internal control;
- monitoring internal control continuously and periodically to ensure its objectives are being achieved;

This proactive role of internal auditors expands the perceived traditional reactive role of just identifying weaknesses and in suggesting improvements in the system.

The following extract from the Standards for the Professional Practice of Internal Auditing in the Commonwealth Public Sector, The Commonwealth Department of Finance standard is derived from Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors, 1978 (page 6). derived from the Institutes Standards and issued by the Department of Finance as an indication of best practice in relation to scope of work, is also a useful summary of what I think can be reasonably expected of internal auditors:

*The scope of the Internal audit should encompass the examination and evaluation of the adequacy and effectiveness of the organisations system of Internal Control and the quality of performance in carrying out assigned responsibilities.*

***Reliability and Integrity of Information*** - Internal Auditors should review the reliability and integrity of financial and operating information and the means used to identify, measure, classify and report such information.

***Compliance with Policies, Plans, Procedures, Laws and Regulations*** - Internal Auditors should review the systems established to ensure compliance with those policies, plans, procedures, laws and regulations which could have a significant impact on operations and reports and should determine whether the organisation is in compliance.

***Safeguarding of Assets*** - Internal Auditors should review the means of safeguarding assets and, as appropriate, verify the existence of such assets.

***Economical and Effective Use of Resources*** - Internal Auditors should appraise the economy and efficiency with which resources are employed.

***Accomplishment of Established Objectives and Goals for Operations or Programs*** - Internal Auditors should review operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned.

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No matter how we expand the traditional role of internal audit and broaden the scope of findings and recommendations, I cannot over stress the importance of follow-up audits to ascertain action taken by management on recommendations. This is especially important because the implementation of audit recommendations reflects to a large extent on the impact of internal audit.

Section 440 of the Standards for Professional Practice of Internal Auditing states that:

Internal auditors should follow-up to ascertain that appropriate action is taken on reported audit findings. Internal auditors should determine that corrective action was taken and is achieving the desired results, or that senior management or the board has assumed the risk of not taking corrective action on reported findings.

I suggest that at least quarterly, the Audit Committee should be provided with a summary of outstanding action on recommendations. If necessary, a comprehensive report should be provided to the Audit Committee where recommendations considered to be of importance are either only partially or not being implemented by management. It goes without saying that a comment that the audit recommendations will be implemented is not sufficient follow-up action.

Experience shows it is probably unrealistic to expect internal audit to be given the necessary resources or have sufficient expertise to provide such extensive coverage as I have discussed on an ongoing basis. Depending on the nature and size of an organisation, the ANAO considers that, ideally, internal audit should undertake a balanced mix of audits. The mix will be guided by the Boards and/or management's perceptions as to the risks and opportunities facing the organisation and the resources available to internal audit. This is an area where the perceptions of a Board/management and internal audit may very well differ. Whatever the outcome, what is important is that the appropriate balance is properly debated and decided on by the organisation. Differences are likely to be minimised if internal audit is highly regarded in its advisory role by both management and the Audit Committee that is, it has a reputation of providing a professional, expert service. It follows, therefore, that internal audit must have appropriate recruitment, training and other personnel strategies in place in order to provide staff with the necessary skills to provide highly specialised advice to management and to undertake the mix of audits programmed.

One important way of assisting in this is through secondments within an organisation and also to other agencies, both public and private. The ANAO has found, that not only can a managed program of secondments greatly assist in the professional development of the officers concerned but it is also a very useful source of fresh ideas. I would tend to favour ANAO exchanges with internal audit groups for varying periods, although they do not necessarily have to be contemporaneous.

## **An Emphasis on Quality Advice**

Where the focus of its role is on ways to improve organisational performance, internal audit must adopt a proactive approach in providing management with highly

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specialised, independent advice on improving the organisations efficiency and effectiveness and adding value in areas such as:

- revenue enhancement and cost reduction;
- improving customer relations;
- maximising the benefits of technology;
- evaluation of management control;
- improvements to achieve operational best practice;
- top quality management; and
- timely problem identification and analysis.

As mentioned previously, in order to fulfil this extended role, it is important that internal audit recruit resources with experience, skills and disciplines appropriate to its audit responsibilities. This is also important for quality assurance even if full accreditation is not sought. In this respect we need to be careful we do not unduly encourage a focus on the assurance process rather than on the outcomes to be achieved. Sometimes there can be a confusion of means and ends in the quest for quality performance.

The audit function is very much a people business and the future of the internal audit function rests with the professionalism and expertise of its staff. It is therefore necessary for internal audit units to establish and develop an appropriate Personnel Development (PD) Strategy which will equip all levels of staff with the skills necessary to meet the challenges internal audit will face in the future. It is also important the strategy is supported and oversighted by the Audit Committee.

Minimum annual professional training requirements should also be specified for staff and appropriate follow-up reviews undertaken to ensure that these requirements are achieved.

Professional Development is an area in which there is more scope for co-operation between internal and external audit. As mentioned previously, similarities in the nature and scope of activities performed by internal and external auditors justify, in my view, further consideration of the possibility of co-ordinating PD programs with the potential for more value being obtained for the training dollar.

## **Involvement in Management Consulting**

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There is an ever increasing requirement for auditors to act as management consultants in a diverse range of areas. In view of current best practice trends, consulting could become a major part of the internal audit service to management, as it would be seen as directly adding value to the organisation.

Internal audit is regularly required by management to undertake consultancy type activities. Such activities may be in areas covered previously under the relationship with evaluations and reviews, particularly where there is no separate organisational unit for the latter. The activity could be the design of, say, new information technology (IT) or other systems. As a result, internal audit might perform some or all of these activities as part of the internal audit function.

This involvement can be advantageous, by providing:

- an efficient use of limited skilled resources, particularly in smaller organisations;
- a more productive use of audit skills;
- an opportunity for internal audit to raise its profile and increase its impact; and
- a means for internal auditors to gain wider knowledge and experience

Such involvement can, however, have adverse implications for internal audit independence and coverage:

- by limiting internal audits ability to provide independent assurance about those activities; and
- by the risk of inclusion of additional tasks in the work program reducing internal audits ability to complete vital audit tasks.

Internal audit should advise management of the opportunity costs associated with internal audit involvement in consultancy type tasks and such tasks should be referred to the Audit Committee for consideration as part of the Committees ongoing oversight of the internal audit function.

## **ADDING VALUE AND MEASURING PERFORMANCE**

One of the key issues to be addressed by internal audit is how to satisfy management that it is adding value to the organisation. As with other areas of an organisation, internal audit must be able to demonstrate that it can add value and thus be seen, in a real sense, to pay its own way. Best practice requires that indicators used for

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measuring internal audit performance should be linked to an organisations mission and objectives to ensure that internal audit provides a value added service relevant to the needs of management.

I would therefore expect that:

- internal audit develop and implement a system of qualitative and quantitative performance indicators to measure its own performance; and
- internal audit performance measures would be linked to the audit mission and objectives and should be based on outcomes and not just be a measurement of the efficiency of resource use.

Both internal and external audit lack credibility if they do not adopt the practices they are advocating agency management implement as necessary to demonstrate accountability for their performance.

To add value in a climate of continuous improvement flowing from an ever changing public sector environment is, in my view, the real challenge facing internal audit in the future.

## **Delivering on Quality**

Quality assurance is an important way of maintaining internal audits capability to perform its functions in an efficient and effective manner. It is also important in achieving and maintaining a high level of credibility with management, the Audit Committee and external audit, all of whom rely on the service provided by internal audit.

A quality assurance program helps ensure adherence to the audit charter and compliance with professional standards, guidelines and ethical conduct. As a minimum, I suggest that such a program should comprise the following three basic elements:

- *Supervision:* each auditors work should be subject to continuous review by an audit senior having regard to:
  - compliance with the audit program;
  - adequacy of work performed;
  - future training and career needs; and

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- behavioural skills.
  
- *Internal review:* these reviews should be undertaken periodically by the Director of Audit and should address the performance of the internal audit function using agreed review procedures and programs. Results of the reviews should be reported to the audit committee and to management to promote the internal audit role within the organisation.
  
- *External review:* the Institute of Internal Auditors requires that external reviews of the internal audit function be undertaken every three years in order to assess the quality of the functions operations and to report on compliance with professional standards. The audit committee should ensure that such reviews are undertaken by appropriately qualified peers using outsourcing arrangements, the ANAO or such other process deemed appropriate.

A quality evaluation is the best protection for a well performing program or activity.

## **Using Information Technology for Strategic Advantage**

Information technology (IT) in its broadest sense as having a fundamental impact on our business. It is therefore essential that internal audit recognises this fact and responds accordingly. IT is a means to an end and can facilitate the use of information in all its various forms. The information that any organisation has is one of its major assets and the proper management of this resource can provide it with a significant strategic advantage. Once again, this is where internal audit can add value to the organisation.

Internal audit needs to explore ways in which it can contribute more in areas such as the development of new IT systems, as well as identifying cost-effective ways of reviewing IT systems on an ongoing basis. In many organisations it would be appropriate for internal audit to have in place an Information Technology Strategy addressing requirements for state of the art hardware and integrated audit technology software products that will best meet public sector internal auditing requirements and responsibilities. As the ANAO has found in respect of its financial statement audits, the solutions offered by the private sector may often be appropriate for the purpose.

The ANAO has established a strategic relationship with the international accounting firm, Price Waterhouse. The aim is to equip our auditors with state of the art hardware and integrated audit technology software products. We are `customising the product to the public sector. Importantly, in my view, the approach is being adopted elsewhere, for example in Canada and New Zealand for external audit purposes and in the Australian Taxation Office and the Australian Customs Service for internal audit purposes. The wider use of such systems should facilitate both the sharing and quality assessment of information and audit activity. It should therefore result in more cost effective auditing.

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The use of IT tools is also a crucial element of performance audits which address efficiency and administrative effectiveness. Increasingly, performance auditors have a suite of automated tools to assist them in carrying out the more complex audit assignments. Internal audit needs to keep abreast of the availability of such tools which include survey software, database packages for data analysis, and data interrogation systems, in order to continuously improve the quality and efficiency of its audits.

In summary, the following are two of the challenges I see facing internal auditors in relation to information technology:

- developing methodologies and computerised tools to keep pace with changes occurring in data management and communication; and
- maximising the benefits of IT to improve audit quality and increase productivity.

## CONCLUDING REMARKS

The challenge for internal audit in the future is to add value to an organisation by improving performance through identified best practice. This objective can only be achieved if internal audit has resources with the appropriate skills to provide highly specialised and focused quality advice to the Audit Committee and ultimately to management. Such advice must be provided within an environment that ensures the independence of the internal audit function. I appreciate this is not a simple bill of goods.

I do not underestimate the significance that internal audit has for agency management in terms of assurance, particularly on financial systems, controls, accounts and conformity with Audit Act requirements. Such a role is highly valued. But this should not be your sole horizon.

Internal audit also has an important role to play in helping to maintain ethical standards in an agency. It can be very effective in fraud prevention and detection. Increasingly, internal audit will be called on for advice on corporate governance issues and on the systems for internal control as both a management and an audit responsibility. The replacements for the Audit Act will be of considerable assistance to agency management and auditors in these respects.

Internal audit, along with other review activities, has the potential to be an important contributor to the ongoing financial and other management reforms in the public sector. This is particularly evident in the growing use of commercial approaches and practices in agencies, a greater emphasis on contract management and quality service delivery and the requirement for accrual based reporting and most likely for accrual accounting feeding into decision support systems. But nobody is necessarily going to issue an invitation to participate in such developments. It is up to internal audit to take the initiative (as it has done, for example, in the area of Risk

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Management) and deliver accordingly. We need to learn how best to market what we have to offer. However, there is no substitute for performance and results.

The ANAO faces similar challenges and I look forward to exploring ways in which we can work together to develop our strategies and maximise our opportunities to add real value to agency management and overall public administration. We can make the one audit approach a reality where there is mutual confidence in the quality of our products. This will not only result in more cost effective auditing but should also provide greater assurance to agency management and to the Parliament. Exchanges in Forums such as today's event are important in these respects. I therefore thank you again for the invitation to participate.

**[Acknowledgement is made of the contributions of Russell Coleman and Lance Carder in the preparation of this address. However, they do not have to take any responsibility for the views expressed.]**