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**Internal Audit in the APS –
Surviving the New Millenium**

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I. INTRODUCTION

The themes of this conference 'Corporate Governance, Risk Management and Resource Management' are very apt and timely. In my view, these are the major pillars on which we will build a more robust and secure future for the internal audit function. They reflect the realities needed to be addressed for survival of the public audit function conducted within the Australian Public Service (APS). Simply put, the challenge is to make ourselves virtually indispensable to decision-makers in a more private sector oriented environment.

While there has been some doubt cast on the value of the traditional audit of financial statements, and even on the statements themselves, I am confident that the audit function will be even more valued in an era of greater contestability and accountability for performance and associated demands for assurance by all stakeholders. But we do have competitors. There is no guaranteed place in the sun. As a departmental secretary indicated to the 1997 Heads of Internal Audit Forum late last year:

'It is your role to make internal audit relevant and operate as part of the organisation.'(#1)

The key to successful auditing is trust. But trust has to be won. It comes with functional independence and objectivity which must be supported by demonstrated performance. That performance in turn largely depends on our skills and professionalism. The adoption of accrual budgeting at the Federal level and the complementary moves to accrual accounting and reporting place an increased emphasis on professional accounting ability oriented somewhat more to the private sector approach. In addition, there will continue to be a premium on investigative, analytical, statistical and communication skills. The last mentioned is essential for any advisory (decision support) role that might be sought and/or required.

In my view, the success of an internal audit function into the new millennium will depend importantly on the extent to which it is effectively resourced and integrated into an entity's corporate governance framework. Internal audit can play a role in establishing better practice performance, financial and risk management frameworks and a responsive control environment essential for proper accountability, notably in relation to information technology (IT) and other systems. Assurance and decision support are two key requirements.

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Internal audit needs to work in close partnership with entity management but particularly with the Audit Committee and the external auditor to enhance its credibility for objective assessment and advice.

The three new Acts, replacing the longstanding audit legislation from 1 January 1998, offer both opportunities for enhanced performance but also risks, particularly for accountability. They demand greater accountability but place responsibility for it largely on Chief Executive Officers (CEOs) and Corporate Boards. The recent Management Advisory Board (MAB) publication(#2) dealing with best practice financial management will have a pervasive influence for the foreseeable future on the performance framework. It opens up a number of doors for internal audit to play an effective role in the further development of that framework. Failure to do so will see those doors firmly shut as others take the opportunities offered.

Given the time available, I thought it might be of interest to focus mainly on the following three areas:

- the scope and major directions for internal audit to play a role in the changing public sector environment;
- coping with competitive tendering and contracting both in terms of contestability for the function itself and its quality and for overall entity performance; and
- achieving better practice for enhanced professional credibility.

I will be using information for the final area largely from the Australian National Audit Office's (ANAO) recently completed but not yet published *'Benchmarking Study of the Operations of Internal Audit in the Commonwealth Public Sector'* which was based on a survey of 52 agencies using two questionnaires and the follow on draft *'Better Practice Guide - Internal Audit in the Australian Public Sector'*. One questionnaire was based on the Global Auditing Information Network (GAIN) approach developed by the Institute of Internal Auditors (IIA) and the other designed in-house by the ANAO to collect information not covered by GAIN, including questions on internal audit performance indicators. The findings should at least be of general interest to all attending this conference.

II. UNDERSTANDING AND CONTRIBUTING TO OUR CHANGING ENVIRONMENT

All auditors are aware that their ability to add value by their activities depends importantly on their understanding of the 'business' of an organisation and, by extension, the environment in which that business is conducted. Not only

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does this help to ensure that the audit products are timely and relevant but it may also provide an opportunity to influence the direction and impact of changes being made.

Understanding The Current APS Environment

To many it is not news that the APS is going through a period of significant change. The present Government's reform agenda has started to take effect. For example, recent and ongoing legislative reforms include the *Workplace Relations Act 1996*, the *Auditor-General, FMA and CAC Acts 1997*, the still being debated *Charter of Budget Honesty 1996* and the proposed *Public Service Act*. The reforms embodied in such legislation and in Government policy directives, particularly those related to out-sourcing and market testing, directly affect the way in which the executive management of public sector entities need to govern their operations.

In this climate the reconstruction and readjustment of agencies is being accompanied by an intensified public scrutiny and increasing levels of accountability. We are urged to look at ways of adopting more private sector type approaches, assess whether activities should be undertaken in the public service, market test, contract out, be more market oriented and even directly competitive.

A cultural shift is required within all APS entities, necessitating the adoption of a more private sector 'orientation' in attitudes to service delivery, in part reflected by the introduction of client service charters. This imposes a greater focus on service delivery mechanisms such as purchaser/provider arrangements; and more emphasis on efficiency and effectiveness. In particular, there is a demand for both performance management and performance information stressing timeliness, lower cost and improved quality of services and products.

The lessening of prescribed controls in the emerging financial management framework has been counter-balanced by an increased emphasis on accountability for resources and achievement of outcomes, whilst maintaining the probity and fairness expected of the public service.

As a final example, the impending introduction of full accrual budgeting and accounting into core Commonwealth agencies will place a far greater emphasis on financial management and facilitate greater transparency of the cost of program delivery. This heralds the need for management to develop more sophisticated information systems that will incorporate improved forecasting and decision-support analyses.

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Understanding the Organisation's Business

As part of this fast-paced reform movement, there is also a growing awareness within Commonwealth entities, particularly 'core' agencies, of the need for good governance, reflecting how an agency or entity is led and managed to meet government, parliamentary and public expectations. Governance is concerned with structures and processes for decision-making as well as accountability, controls, and behaviour within organisations.

Good governance practices will:

- demonstrate that required managerial disciplines are in place;
- assist with planning and decision making for management;
- complement any review and evaluation of program management;
- identify best private (and public) sector practices;
- establish credibility with external parties; and
- provide a defence against internal/external criticism.

Corporate governance offers an approach by which agencies can mobilise their internal resources to review levels of responsibility and to renew command structures across the organisation. It emphasises the renewal of clear communication and up-to-date information both agency-wide and to all stakeholders.

A key aspect of good governance is to ensure that all participants are aware of, and accept, their roles, responsibilities and accountabilities and that they have a sound understanding and appreciation of their practical importance in the public interest. The framework is very people oriented involving better communication; a more systematic approach to corporate management; a greater emphasis on corporate values and ethical conduct; risk management; skills development; relationship with citizens as clients; development of government service charters; quality service delivery; and published performance measures. In terms of accountability to stakeholders it should be borne in mind that:

'No matter how much governments may refer to their citizens as consumers, the limits of a government's responsibilities to its citizens are far more extensive than that of delivery performance.'(#3)

A well governed agency will achieve better performance: it will have the robustness, the internal cohesion and direction essential to successfully drive

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the organisation forward and to respond quickly and coherently to external conditions. This must add to both the credibility and confidence all interested parties have in our public institutions.

The ANAO publication *'Principles for Core Public Sector Corporate Governance'* published last year(#4) provides an outline of a corporate governance framework for the public sector as well as principles for the operation of a public sector Executive Board. The principles were applied in an audit of *'Aspects of Corporate Governance in the Australian Tourist Commission (ATC)'* which suggested a corporate governance checklist for the ATC Board(#5) .

An effective control structure is a fundamental of good governance. The control structure should facilitate, not impede, outcomes or results, and should be commensurate with an acceptable level of risk, the nature of the agency and its operations. It should assist the CEO or Board to uphold the agency's corporate governance obligations for better performance outcomes(#6) . Effective controls provide assurance that organisational objectives and legal and other obligations are being met and are the responsibility of everyone in the agency and they are effected by staff at all levels.

In another recent ANAO publication entitled *'Control Structures in the Commonwealth Public Sector - Controlling Performance and Outcomes : A Better Practice Guide to Effective Control'*(#7) we indicated that a framework for effective control can only be achieved if, within its capacity to do so, an agency is able to:

- control its environment;
- control its risk;
- control its activities;
- control its information and communication; and
- monitor and review its control arrangements.

The guide defines control as:

'a process effected by the governing body of an agency, senior management and other employees, designed to provide reasonable assurance that risks are managed to ensure the achievement of the agency's objectives.'

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In effect, there is a requirement for the CEO, or Board as the case may be, to demonstrate a commitment to achieving and maintaining an effective control structure. They also need to actively encourage management and staff to become more control conscious in order to achieve better program performance in terms of both outputs and outcomes. It is important to recognise the innate complementary relationships between these imperatives. A risk management approach should be used to determine those functions and tasks that need to be controlled. A particular advantage of the guide is that it provides agency management with a good appreciation of the framework by which the ANAO undertakes assessments of control structures supporting financial statements, thereby bridging any audit expectation gap that may exist.

Control activities should be designed and implemented to mitigate the potential risks facing the organisation(#8) . There needs to be open lines of communication to encourage high morale and a feeling of unity throughout the organisation. As well, management needs to monitor and review performance to ensure that control activities are operating and objectives are being achieved efficiently and effectively.

The Contribution of Internal Audit

I have literally only skimmed the surface of some of the critical changes in attitude, process, structure and frameworks that are taking place right now in the APS. The challenge for internal audit is to remain relevant in such an environment. This can only be achieved if key internal audit staff have a deep appreciation of these changes and the consequent implications for their agencies and entities. And this requirement does not just apply to the Commonwealth situation as we witness similar changes occurring at State and local government levels as well as in our own geographical region.

The traditional role for internal audit is well documented and understood. It centres on the control structure of an agency. An effective internal audit operation assists management and the CEO to maintain and refine the control structure through ongoing evaluation of its effectiveness. Internal audit should look to ensure that an agency's control structure:

- improves accountability;
 - promotes ethical and professional business practices;
 - advances risk management;
 - enhances communications, decision making and performance reporting;
- and
- contributes to quality outcomes.

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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. Internal audit needs to take a more proactive role and in so doing should:

- identify risks with the potential to affect the achievement of an organisations objectives;
- ensure that effective controls are established by management to mitigate identified risks; and
- measure performance, both financial and operational, through the use of appropriate evaluation tools which will enable the adequacy and effectiveness of internal control to be measured.

There should be appreciation within agencies that internal audit is itself an integral part of the monitoring and review element of an effective control structure, as is the audit committee which should ensure that internal audit coverage includes the whole control structure. That should be a 'bread and butter' exercise.

The trend toward a greater decision-support and evaluation role for the financial function of entities away from their traditional transaction processing role has to be equally mirrored in internal audit's activities. I am not advocating a management consulting-type role per se for internal audit but suggesting that there can be a two-way benefit from a better use of the type of skills, experience and knowledge internal auditors bring to the agency/entity.

Internal audit has a key role to play in the new environment in keeping the CEO informed of the efficiency and effectiveness of resource usage, of the achievement of corporate goals and objectives and more importantly a role of providing expert advice and recommendations for improvement in resource management and accountability.

The increasing focus on corporate governance and internal control consciousness, which is heightened by the adoption of more commercially-oriented approaches and practices in many agencies, the greater focus on quality client service and the increasing provision of such services by the private sector has expanded the potential role of internal audit. In particular, the widespread use of market testing and outsourcing to ensure contestability in all operational areas has introduced a different dimension of accountability. Among other things, internal audit may well need to spend more time reviewing and monitoring contract management and performance. This could also mean developing appropriate skills and practices in accessing private sector providers' premises and cost and financial systems

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and records. I have suggested such audit access should be provided for in 'standard clauses' to be included in outsourcing contracts.

I earlier referred to the need for agencies to manage and budget, as well as report, on an accrual basis. The *'beyond bean counting'* study indicated that only 4 per cent of agencies at the Commonwealth core government level had operated accrual reporting internally (#9) . Most agencies will start to implement full accrual accounting systems during this financial year. Management will be looking for advice on the implementation and oversight of such developments from the internal audit team as Chief Executives are now legally accountable for the management of their organisations' resources under the new financial management and accountability legislation.

Internal audit are ideally placed to assist agencies maintain good corporate governance practices by promoting, and participating in, regular surveys of staff, management and clients to assess:

- leadership issues across the organisation;
- any staff morale concerns;
- perceived problems within any aspect of the agency's operations;
- the ethical conduct and APS values-based approach being adopted;
- the control consciousness of staff;
- the adequacy of communication;
- adequacy of control structures;
- the adequacy of reporting and monitoring;
- the quality of service provided, timeliness and problems associated with service delivery; and
- how well the agency's goals and objectives and vision for the future are being met and that management strategies are effective.

By having a real and visible presence in the agency, internal audit is also well placed to promote the principles of good corporate governance and act as a deterrent to the adoption of poor practices. To be able to fulfil this role and meet the challenges ahead it will be fundamentally important to establish a close working relationship with key internal stakeholders. These will include the 'governing body', be it a board or a chief executive, as well as with the audit committee and any chief financial officer.

Equally, the traditional role of financial managers in the APS is being challenged. As stated in *'beyond bean counting'*, APS agencies need staff with:

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'value adding financial analysis skills (which) is replacing the need for bean counting skills for number crunching and transaction processing.'(#10)

A complementary observation by the Management Advisory Board (MAB) is even more compelling as follows:

'A major risk for many agencies attempting to adopt best practice financial management is the failure to obtain the appropriate staff skill base.'(#11)

By analogy, internal auditors need to ensure they have the financial management and information technology skills required to assist:

'Chief Executives and senior managers to stimulate interest and drive improvements in financial management practice within agencies.'(#12)

Without such knowledge and skill sets it will not be possible to create the credibility and trust I referred to earlier. This in turn places the future of internal audit under the microscope. As chief executives and financial managers, particularly in core government react to the change that is occurring, sharpen their own skills and improve their knowledge, they will become more discerning and better able to examine and assess critically internal audit performance.

At the same time as governing bodies come to appreciate the full significance of the need for an effective control structure and of sound governance principles it can be anticipated they will look first toward their existing assurance processes, of which internal audit lies at the heart. Our recent survey highlighted that internal auditors regard 'compliance' and 'internal control' as their primary focus with a lesser concentration on efficiency, operational issues and financial matters.

Internal audit must position itself now to be able to provide management with the advice and assistance to help them manage through this current period of legislative and financial reform and to help implement many of the recommendations in *'beyond bean counting'* which is likely to have a considerable impact on the APS for the foreseeable future.

Within the APS and more generally in the public sector, compliance will continue to be an essential element of accountability even if not the

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dominant culture of public service as frequently asserted it has been in the past. Compliance does not only relate to legal responsibilities, important as they are. Public servants are expected to implement specified government policy and to identify and deal appropriately with any tenuous or apparent contradictions between that policy and program objectives. Such issues need to be addressed directly within the established control structures which should ensure that any risk is identified and dealt with effectively.

An Emphasis on Quality Advice

Where the focus of its role is primarily on ways to improve organisational performance, internal audit must adopt a proactive approach in providing management with highly specialised, independent advice on improving the organisation's 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.

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.

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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 cooperation 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 coordinating PD programs with the potential for more value being obtained for the training dollar.

Involvement in Review and Evaluation

There is an ever increasing requirement for auditors to be part of review and/or evaluation activities in a diverse range of areas. In view of current best practice trends, such participation could become a major part of the internal audit service to management, as it would be seen as directly adding value to the organisation. However, there are potential conflicts of interest likely in advisory/auditing activities which need to be managed sensibly. Nevertheless some evaluations would benefit markedly from skills and knowledge of internal audit staff. An example could be the design of, say, new information technology (IT) or other systems to ensure they meet accountability requirements and add to the confidence and assurance of agency users.

Such audit 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 audit's ability to provide apparent 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.

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Internal audit should advise management of the opportunity costs associated with internal audit involvement in review type tasks. Preferably, such tasks should be referred to the Audit Committee for consideration as part of that Committee's 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 measuring internal audit performance should be linked to an organisation's 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 would 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 also 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 should implement as necessary to demonstrate accountability for the latter's 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.

Other 'added-value' areas where internal audit can assist include:

- reviews and sign offs of all new systems during implementation stage to ensure that all problems can be quickly identified and corrected;
- playing a considerable role in managing, overseeing and reporting a controls self-assessment program within the agency;
- undertaking, oversighting and providing training on the agency's risk assessment program;

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- being pro-active in identifying and targeting high risk areas for review or attention (involving high dollar values and/or the risk of political embarrassment);
- undertaking and coordinating benchmarking studies of program areas' operations on a regular basis to ensure best practices are continually being identified and introduced to ensure contestability of functions;
- with the current trend to continue to outsource more of the APS operational functions, monitoring of the effectiveness, efficiency, consistency, probity and propriety of contract management; and
- assisting with the development of systems and controls to ensure best practice, for example, in the preparations of monthly and annual accrual financial statements and budget figures, cash management, payment of accounts and asset management.

In summary, the role of the internal audit should become one of a high profile and well respected financial and IT systems and controls adviser and reviewer, particularly in providing assurance to management and assisting in performance assessment. It should aim to earn the full support of senior management so that internal audit is regarded as an important contributor to monitoring and overseeing agency operations and helping to meet the changing requirements in accountability and performance improvement.

This is likely to occur if the role of internal audit in each agency is critically assessed, and redefined, to include, in most cases, evaluation, decision support and an advisory role. The quality of staff has to be a priority; they need to have a good understanding and knowledge of the agency; be technically qualified; have relevant experience and skills; have the ability to market their role and expertise; and a strong commitment to providing management and the CEO with quality service. In particular, internal audit needs to provide relevant quality outcomes, on a cost effective and timely basis.

III. DEALING WITH CONTRACTING AND CONTESTABILITY

The Government has accepted the basic principles set down by the National Commission of Audit(#13) for determining what activities should be undertaken within the public sector. That report had a significant influence on the move to greater privatisation and outsourcing of government services and activities. And it has also meant that, even traditional 'core' government services, have become more contestable or have had to be more directly competitive with private sector providers. Undoubtedly, one of the most significant developments in APS reform has been the requirement to test the market with a view to determining the most efficient and effective method of service delivery. However, in the words of one practitioner:

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'Allowing a Yellow Pages approach to become the dominant philosophy will almost certainly result in silly outcomes.'(#14)

Competitive Tendering and Contracting (CTC) is resulting in greater contracting of what has been regarded as traditional core government services which in turn is creating new risks for management and the CEO which need to be managed. An increased internal audit role in these areas can greatly assist management with the management of these risks by providing the CEO and management with assurance on the adequacy of contracting guidelines, systems and controls, specific contracts and overall contract management.

Concerns have been expressed by various Parliamentary Members and Committees and the Ombudsman about the implications of apparent contracting-out of accountability. The Ombudsman has rather colourfully referred to the situation as a 'black hole' or 'twilight zone'(#15) . The Ombudsman's 1996-97 Annual Report highlighted a range of complaint issues created by contracting out, including:

- muddy and often contradictory rules associated with contracting out;
- problems for citizens seeking redress for poor service or other damage created by contracted service providers;
- buckpassing of responsibility for problems between a government agency, contractor, and/or insurer;
- confusion between the agency's duty of care to the client, and its commercial priorities; and
- arguments about 'commercial in confidence' considerations being unnecessarily and indiscriminately pitted against an individual's 'right to know'.(#16)

The basic question continues to be 'who is accountable for what'? By whatever means, there seems to be general agreement that the agency concerned is primarily accountable. But in practical terms, the answer is not quite as simple as that. Accountability inevitably involves some costs and/or sacrifice of efficiency. Outsourcing accentuates the trade-off. In the words of Richard Mulgan of the Australian National University:

'Denials of such a trade-off are fallacious rhetoric.'(#17)

In my view, the issue is about the information necessary to assess and decide how that trade-off should be resolved. I am confident auditors can make a contribution to elements of such a decision. The issue is not about

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outsourcing or privatisation per se but about achieving value for money outputs and outcomes and meeting the accountability requirements of the Government and the Parliament. Any trade-off between those two requirements is likely to be simpler in the non-core more commercially oriented segment of government and for 'commodity' type outputs whether services or products.

Experience has shown that the decision to undertake contracting needs to be fully informed at the outset if it is to succeed. In deciding whether or not to outsource a function or operation, management first needs to:

- identify in detail the nature, quality, quantity and timing of outputs required (by this I mean services or end products);
- determine the ideal skills mix and resources required to produce the desired outputs;
- assess if current staff can provide, or how easily it would be to employ staff to provide, this service;
- fully cost out providing the outputs (as identified) in-house, and
- identify the potential risks or costs to the agency of contracting out and what strategies, if any, the agency has to put in place to manage these effectively.

Only after going through these basic steps can managers make an informed decision on whether or not to test the market to see what it has to offer and ensure that any outsourcing decision is in the interests of the organisation. In a recently completed inquiry the Senate Finance and Public Administration Committee observed that:

'A recurring theme of the literature on outsourcing is that it is not a panacea nor a convenient 'quick fix' for a failing in-house system and that the benefits may be realised in areas other than cost savings.'(#18)

Indeed there may not be any cost savings or only those associated with business process re-engineering or 'right-sizing' initiatives rather than with the outsourcing itself. On the other hand, it may provide options to management to improve performance that are simply not available in-house.

Deciding to Contract-Out Internal Audit Functions

With increased pressure upon APS agencies to become contestable, more and more agencies are electing to use contractors. APS agencies tend to

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outsource internal audit more extensively than agencies outside the APS. Our 1997 survey results indicated that contract resources are mostly provided by the large multinational accounting firms. Many from the private sector may be surprised to find the magnitude of internal audit work undertaken by contractors. 60 per cent of all agencies surveyed, which included most of the larger APS agencies, use contractors to undertake some or all of their internal audit work and 58 per cent of APS agencies contract out their IT audit functions.

The decision to outsource internal audit services, particularly in larger agencies, may need to be considered carefully by CEOs with their legally specified accountability imperatives since 1 January last. Larger agencies require a comparatively larger internal audit resource base and are therefore more likely to be able to attract and retain the necessary skills and knowledge within the agency. As well, the internal audit function does not have to be narrowly focussed and should be able to contribute to the establishment of a sound framework of accountability within the agency; provide greater assurance on the control environment, including fraud control plans and ex-ante as well as ex-post reviews; and assist in the implementation of effective risk management approaches incorporating risk assessment, analysis, prioritisation and monitoring of performance. The audit committee, in selecting contractors, needs to be aware of the wider skills base required from contractors in larger agencies. This may be necessary as the result of combining the internal audit role with evaluation and/or review.

Consideration of outsourcing the whole or a part of internal audit's activities must then venture beyond narrow capability deficiencies. The audit committee needs to consider the strategic importance of the internal audit function and the potential for an outsourced arrangement to impact positively on the agency's effectiveness. One concern is that contracting accounting firms/auditors should not be seen as also outsourcing management's financial oversight and reporting responsibility, in particular if the outsourcing is quite narrowly focussed, say, on financial statement preparation or even on an ad hoc systems control assurance assignment.

The decision to outsource the function depends very much on just what kind of internal audit service agency management needs, the skills mix required of staff, the overall costs of internal operations as opposed to outsourced alternatives and the confidentiality and sensitivity of information potentially accessible by internal audit. There could be some argument about a possible conflict of interest for the major accounting firms who are also tax specialists undertaking the internal audit function in the Australian Taxation Office. Apparent conflicts of interest are important in an area where objectivity is required. These should be identified and assessed. Any decision by management on outsourcing should, then, be made on a realistic assessment of value for money.

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There are potential advantages and pitfalls in any outsourcing arrangement. An important observation I would make is that the key to any outsourcing arrangement is the need to retain the capacity to effectively manage 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 the outcome required by the audit committee to whom the contractors are ultimately responsible. Management should play a major role in determining the scope and focus of internal audit activity. However, the audit committee should seek to influence the strategic direction taken by internal audit and in doing so should also consider the cost-effectiveness of using internal audit in a complementary role with external audit.

In my view, internal audit staff (both in-house and contractors) need to have a sound appreciation of the current and proposed public sector reforms, as I indicated earlier, particularly in the area of financial management and administration. Executive management would like to think that personnel engaged in the internal audit function have a real commitment to, and ownership of, the organisation's objectives, values and code of conduct. I would also like to see a commitment to public service and a well developed sense, and understanding, of public accountability. However, we need to be well aware of the limitations of any outsourcing contract particularly those of a 'discrete' nature where the major obligations of each party are clearly specified in the contract. In particular few would support a situation where:

'... accountability is now to be left hanging on the drafting ability of lawyers who are neither elected nor accountable to the electorate through Parliamentary avenues of accountability.'(#19)

Specifying detailed obligations differs from a 'relational' contract where there are implicit agreements based on mutual understanding and trust. In practice, accountability has to be seen in terms of the contract clauses with the inevitable conclusion that:

'...because it is impossible to specify all possible eventualities in a contract, there will always remain a significant difference between the unconditional, open-ended right of intervention accepted by public servants and the contractually circumscribed conditions accepted by contractors.'(#20)

While there are undoubtedly efficiencies and cost savings resulting from relational contractual arrangements, particularly where the partnership or alliance is on a medium or longer term basis, there are also difficulties of shared responsibilities (accountability). For example, the private sector partners may be willing to comply broadly with public service values, requirements for maintenance of privacy and protective security, freedom of

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information, record keeping and archival demands but it is difficult to hold them legally responsible without a contractual obligation. Yet the agency concerned would be so accountable. Consequently there is an issue about how practical or real a relational contract can be where such broad accountability requirements apply. This has also drawn an observation about how extremely difficult such an outsourcing agreement is 'for Parliament or watchdogs such as the Auditor-General to adequately scrutinise'(#21) . I would add that there is also a question as to Parliament's acceptance of the possibility of greater efficiency at the expense of these kinds of issues - that is the kind of trade-off, suggested by Richard Mulgan, referred to earlier. It should be noted that, for example, the Government intends to amend the Privacy Act:

'to ensure that it applies to contractors supplying services to the Government in relation to personal information held by them on behalf of the Government.'(#22)

The ability of an outsourced internal audit cell to possess adequate knowledge of the implications of public sector reforms and of the organisational intricacies and complexities of the agency and its programs is surely diminished without at least some first-hand day to day exposure to the business/functions. The latter could be provided by a complementary in-house overseeing capability. The latter should have the confidence of management to be able to identify, articulate and provide credible agency-based approaches and practices to fulfil its accountability obligations and enhance its overall performance. Again, **it is a question of establishing the 'right balance'** to meet the corporate governance needs of the agency. Thus it is essential for any contracted auditors to acquire a good understanding not only of the agency's business but also of the changing public service environment if they are to add value to the agency's functions.

I suggest that the audit committee, if satisfied with the longstanding contribution and available expertise in-house, would need to give very careful consideration to any proposal for outsourcing simply on some hourly cost basis or on experience with a narrowly-oriented audit task. Assessment of cost effectiveness should start with realistic identification of agency risks and a hard-headed analysis of what an efficient internal audit function could do to assist in effectively managing those risks. No doubt this assessment would require an element of judgement which should be made clear in the final decision.

One area worth examining is whether outsourcing is being used as an opportunity for a disguised down-sizing. In such a situation the committee should ensure that management have taken appropriate action to replace any resulting reduction in compliance and monitoring activities with other appropriate alternative measures. The issue is simply about effectiveness and the overall performance of the agency.

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This trend to outsource will continue until in-house internal audit operations become more contestable. By this I mean more highly skilled and focussed on their role in assisting management to achieve cost effective control structures in particular.

Other Considerations in Outsourcing Internal Audit

Why are APS managers and CEOs looking to outside experts to provide them with assurance on the reliability and adequacy of their operating systems and controls, and to assist them in improving their operational performance? Why aren't they using their agencies' in-house staff? I suggest that many CEOs are looking outside their agencies for assurance because they judge that external consultants, particularly from the large accounting firms, have a broader range of experience and expertise on which to benchmark their findings, recommendations and advice. This judgement may also reflect the added complexity of their own environment and desire for assurance where they are more personally responsible for the accountability framework and agency performance. Unfortunately, it may also reflect a perceived gap in the professional capability of in-house and outsourced internal audit services.

Contestability applies just as much to internal audit as it does to any other operational function. In-house internal audit functions will only survive if they are contestable. By that I mean the in-house staff must have comparable skills and provide a comparable product at a competitive price. In becoming contestable and adopting best practice internal audit operations are being totally restructured, downsized and often given the added burden of managing contractors. As you will be aware, this level of change does not happen quickly and it appears that many internal audit areas are still in the transitional phase, attempting to justify their continuing existence. *The beyond bean counting* publication indicates the need for senior management to grasp the importance of the financial reform framework and adopt improved financial management initiatives. It stresses, for example, that:

'In a best practice financial management environment, the role of corporate finance staff is to provide expert advice to support the decision-making process of managers.'(#23)

The publication refers also to the capacity to provide 'business management information' and the need for 'assurance skills'.

Internal audit could be a logical choice to help provide the required financial advice and assistance to managers to enable them to maximise their financial performance. This advice could be provided by in-house staff where

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they have the skills, and by using contractors to fill any gaps as necessary. In my view the MAB publication provides internal audit with a great opportunity to extend and expand their advisory services, particularly in the areas of financial management, accrual accounting and budgeting. Identification with the objectives and values of an agency and its performance are endemic to core activities. It is not difficult to identify internal audit in this category providing the resources and scope of work justify that investment.

From an external audit point of view, outsourcing of Internal Audit is viewed as another means of service delivery. In short, the ANAO neither supports nor opposes outsourcing of the function per se. But we are very concerned about accountability for performance including the exercise of public service values and ethical standards. In essence, the outsourcing decision depends very much on just what kind of internal audit services management requires. I am particularly sympathetic to the situation confronting management in determining viable arrangements in small agencies. There is clearly a 'critical mass' problem which impacts adversely on the recruitment and retention of the requisite professional skills.

Any decision by management on outsourcing should be made on a realistic assessment of value for money given the risks and responsibilities involved. This assessment will vary with the circumstances of each agency and the trade-offs individual managements are prepared to consider, particularly in their control environments and within the broader accountability responsibilities to the Parliament. It is important that such assessments are made within the ambit of their corporate governance arrangements so that the full implications are reviewed but not in any partial sense where the consequences are only discovered later in some accountability failure, impacting adversely on the whole agency.

An interesting observation was made in an audit conducted by the New South Wales Auditor-General late last year:

'Any economies of scale through shared audit management were felt to be less important than a close, and unambiguous relationship with one Board and one management team.'(#24)

In a more general vein the following observation should be kept in mind when considering any outsourcing approach:

'Continuity and trust are valuable assets which are more easily dismantled than built up again.'(#25)

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Unfortunately, history has shown that agencies have rated activities such as financial management, evaluation and internal audit as low priority in resourcing decisions. Hopefully this is will now be seen as counter-cultural to the current reform package and the recommendations included in '*beyond bean counting*'.

Risks and opportunities associated with outsourcing Internal Audit

There are obvious opportunities and risks which need to be managed when outsourcing internal audit services. These have to be weighed up to ensure agencies are ultimately benefiting from such a decision. Internal audit contractors should cost less; the larger firms in particular should be able to provide a greater level of expertise and provide a more efficient service than in-house staff. The concept of value for money applies in assessing these various advantages.

Any opportunities need to be weighed up against possible risks. By using contractors there is a risk that the agency will lose control over the nature, quality, timing and extent of work undertaken and service provided to management and the CEO. There is also a real risk that the corporate knowledge of the agency may be lost; the level and quality of service will diminish; contractors may not understand accountability notions and requirements in the public sector; conflicts of interest, and questions of divided loyalty and different values may arise; there may be problems with confidentiality of data; and the real cost of using contractors may actually turn out to be more than that of the in-house service down the track.

I reiterate that a management decision, hopefully endorsed by the audit committee, to use contractors in place of in-house staff to provide internal auditing services should only be made once a business requirement and skills profile has been drawn up and where it is found that the level of required expertise and skills are not available in-house and it is more cost effective to use contract staff.

As with the external audit function the necessary skill sets and knowledge requirements for internal audit staff are varied and complex and rarely reside wholly within one individual or even a small number of people. This can be a major factor impinging on the effectiveness of small internal audit sections typically found in the smaller agencies. A particular problem is to attract suitable candidates at the levels necessary to be credible both to potential recruits and to those with whom they would be working. As well, there is the difficulty of maintaining professional expertise with little or no peer contact. Nevertheless there may well be compelling reasons for simply complementing an in-house capability with the required external skills and capacity.

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Management of internal audit contractors

The real challenge for APS management is to manage effectively internal audit contract services provided, thus minimising the risks and maximising the opportunities. Agencies need to ensure that internal staff managing contractors are sufficiently senior and expert enough to make a difference to their effectiveness. The contract managers need to ensure that the contractors are providing the service agreed to in the contract and in the annual operational plan and, in doing so, need to ensure that:

- the scope, coverage and standards of service delivery of the contract tasks are clearly set out and agreed up front;
- contractors are undertaking audits in a timely and professional manner within the agreed time frame and budget;
- audits are undertaken by contractors with the relevant skills, qualifications and experience, the capacity to introduce new skills and methodologies, and with an appreciation of APS processes, accountability, and confidentiality of agency information;
- all work is to be conducted in line with the Institute of Internal Auditors (IIA) auditing standards;
- there are controls over access to sensitive commercial or customer information and checks in place to ensure that no potential conflicts of interest occur;
- all working papers remain the property of the agency and that the client/agency and their internal auditors will have access to the contractors and their working papers;
- all draft reports:
 - are provided to the auditee areas for comments and input and that these comments are included in the final reports
 - are balanced and include both weakness and strengths along with recommendations on
 - include economy and efficiency recommendations
 - include an opinion or rating on current operations;
- the contractors are providing a service to the client, and in doing so are available to attend audit committee meetings and other meetings with senior management as needed;
- they are not to undertake consulting work within the agency without the contract manager's knowledge and agreement to prevent any potential conflicts of interest;
- the all-up cost has been compared to the fully costed use of in-house staff and justifiable where higher on value for money grounds;

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- arrangements are in place to ensure access to relevant experience, information and papers after the task ends, and ownership of intellectual property;
- there is ongoing monitoring and evaluation of performance, follow up of recommendations and post implementation reviews; and
- there is provision for conflict resolution and for dealing with unsatisfactory performance.

There is also a need to ensure that the contract selection process is fair and ensures that the best possible contractors are selected. Within the public sector the open tender process is extensively used as well as fairly standard forms of contracts which make sure required outcomes are specifically defined but also endeavour to ensure that there is a genuine 'partnership' relationship created. For individual contract auditors, the contract selection process should ensure that:

- contracts are to be for a set term, (1 year would seem an appropriate term with no more than two annual renewals and a maximum contract term of 3 years before returning to the market);
- contract staff are individually required to sign deeds of confidentiality which include a non-disclosure clause;
- contract staff are individually required to disclose any actual or potential conflict of interest;
- contract staff are hired under a formal contracts through a company that will be responsible for carrying out defined tasks and who are paid according to their skills, the tasks undertaken and the market conditions at the time of the engagement; and
- contracted staff are not eligible for the agency's employee benefits such as paid holidays or superannuation and are not trained at the agency's expense.

In short, monitoring and managing performance is crucial to the success of any contractual arrangement, including for future similar activities. Building relationships is also essential particularly to engender the confidence, commitment and enthusiasm necessary to achieve the required outcomes. Above all, there needs to be pro-active communication and good information flows between all concerned. (#26)

IV. PURSUING BETTER PRACTICE AND QUALITY OUTCOMES

Internal Audit - Where has it been?

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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 in the public sector, internal audit operations have been aligning their philosophies and approaches to fit into and facilitate the many changes which have been taking place.

In 1989 the ANAO 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 and also found that a gap existed between service levels expected of internal audit by management and the service provided. In the following year the ANAO undertook a follow up 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 1993, entitled *A Practical Guide to Public Sector Internal Auditing*. (#27)

Four years on, and in light of considerable legislative and operational changes within the APS, the ANAO has undertaken a benchmarking study to identify public sector internal audit best practice. This was conducted in two parts. The first involving the completion of 'GAIN' (Global Auditing Information Network) questionnaires, the results of which were processed and benchmarked by the Institute of Internal Auditors in the US against the responses to their world-wide population of subscribers. This benchmarking exercise will be conducted over three successive years. The results of this survey were sent out to participating agencies in February 1998. The second part involved the completion of an ANAO based questionnaire which was designed to complement the 'GAIN' survey and canvass responses on internal audit performance indicators. Results of this benchmarking study were also distributed to agencies in February 1998.

A draft copy of the Better Practice Guide will be distributed for comment. Better practices identified in our guide have been developed not only from the ANAO's 1997 benchmarking study into internal audit in the APS and the follow up Financial Controls and Assurance (FCA) audit but also in light of current legislative reforms, and the proposed financial reforms and recommendations highlighted in the Management Advisory Board's publication '*beyond bean counting*'.

How is internal audit in the APS operating and performing?

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The GAIN benchmarking results indicate that current APS internal audit operations, which I might add are often staffed by a mix of in-house and contract auditors, compare favourably with those in other agencies world wide. There are, however, a number of areas where our APS internal auditors can improve and the benchmarking study has highlighted a number of these.

Elements of the Staff Profile of Internal Audit

Last year the ANAO surveyed a range of Commonwealth organisations including departments (and similar agencies) and statutory authorities but not Government Business Enterprises. The survey included entities with in-house, contracted-out and 'mixed' internal and external staffing. The majority of respondents (88 percent) had internal audit units of between 1 and 15 full time staff equivalents. Only one unit included in the survey had more than 50 staff. The following data are therefore more relevant to the smaller internal audit sections in the APS which, in the 'core' government sector, would apply to all but the large revenue and expenditure agencies.

On average, the head of a Commonwealth internal audit unit has around 24 years employment experience which is commensurate with international benchmarks. However, that person is likely to have spent more time in areas outside the Internal Audit unit, including in public practice, than his or her international counterparts. Only one-third have a university degree or post graduate qualification, but a further third have some other form of academic qualification. Less than half have a relevant professional accreditation or certification.

The highest paid head of internal audit in the surveyed Commonwealth agencies receives significantly less than those in all other industry groups in the GAIN database. This comparison holds even when average salaries are compared, where the differential is around US\$40,000 per annum.

The Commonwealth internal audit sections surveyed have a high percentage of staff (63 per cent on average) with relevant qualifications including Chartered Accountant (ICA), Certified Practising Accountant (ASCPA) and Certified Information Systems Auditor (CISA) accreditations. This is significantly more than international benchmarks which are around 45 per cent. An interesting counterpoint to this statistic is that the surveyed entities are much less likely to support the obtaining of qualifications by payment or reimbursement of exam costs compared to their international counterparts. Less than half indicated that this was a policy (compared to over three-quarters in the GAIN database) and most of those who did so made it contingent on the auditor obtaining a pass mark. The surveyed entities also planned for and provided significantly fewer training hours per auditor, around 39 hours per annum, than their international counterparts (67 hours).

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The surveyed agencies with an 'in-house' internal audit unit are strongly disposed to fill internal audit vacancies with staff from elsewhere within their organisation. On average, 70 per cent of staff will have been obtained from this source. This is in marked contrast to international benchmarks which place this source at around 35 per cent which, whilst still the predominant single source, is closely followed by external sources including other organisations (25 per cent) and graduates (17 per cent).

The 'typical' internal auditor will have around 7 years internal audit experience which is commensurate with international experience and will, on average, spend around 3 years in the internal audit unit. Most are likely to exit the organisation on departure from the internal audit unit but there remains a small contingent that move into other areas within the organisation.

These data highlight at least two major areas of concern. First, whether remuneration levels in the APS for internal audit staff are sufficient to attract and retain those employees with the appropriate skills sets and knowledge required to assist management, as discussed earlier in this paper. And second, whether sufficient attention is being paid to the need for ongoing professional development and training required for internal auditors to maintain their skill and knowledge bases.

As a confirmation of these concerns, it is interesting to note from our survey that the area of internal audit staff remuneration and qualifications was of least interest to audit committees in those entities surveyed. This is in sharp contrast to the attitude of audit committees in the private sector as indicated from the IIA GAIN database.

Developing the audit plan

The chief internal auditor/ contract partner is responsible for implementing a cost effective, risk based internal audit program or plan, which aligns with the agency's operational goals and objectives, topics should be selected on the basis of a risk assessment and consideration should be given to management suggestions. This should be submitted before the start of each year to the audit committee for approval.

GAIN survey results indicated that 1 in 3 APS agencies are preparing their annual planning documents without obtaining management input as compared to only 1 in 4 of agencies outside the APS. However, APS agencies see the other important selection factors for determining the annual audit plan including management requests, high risk areas and the cyclical approach, as important as do agencies outside the APS.

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If internal audit is to be more client focussed, involving line management in direct discussions as part of the planning process will pay significant dividends. This is reinforced by the comparatively low rating provided in the survey in relation to a 'customer' satisfaction question on whether internal audit effectively solicited management concerns during the planning phase. When undertaken in a vacuum, there is a significantly greater chance that planning will not detect, and adequately identify, the critical risk areas in an organisation. This type of senior officer involvement may also more clearly 'spell out' to management the changing role and focus of the internal audit function.

Monitoring Internal Audit Performance

Internal audit should set an example for management. To be effective an internal audit function needs to be more focused on outputs and less focussed on inputs at all stages of the internal audit process. The audit committee can assist in this process by overseeing and monitoring all stages of the internal audit operation to ensure that they are focused on management needs, on potential risks to the agency and on the impacts and usefulness of internal audit reports.

How can this monitoring be best undertaken? One answer is to monitor actual performance against set targets or performance indicators. The use of performance indicators is not new. However, our recent survey results suggested that there is a need to significantly improve performance monitoring and to make indicators more outputs/outcomes focused, and less concerned merely with the achievement of specified audit processes. The survey also indicated that performance indicators have only been used to review internal audit performance in 64 per cent of APS agencies surveyed and that only 16 per cent of those that used performance indicators to measure performance indicated they were useful. Performance indicators were only linked to target information standards in 22 per cent of agencies surveyed with that figure only rising to 50 per cent where some were so linked. These statistics suggest that APS internal audit operations lack an appreciation of the value that performance indicators can provide to assist with the management and future direction of internal audit strategies and effort.

There is an obvious need for agencies to rethink performance evaluation, and the indicators used, to ensure they satisfactorily measure internal audit performance. By this I mean the standard and quality of reports; the level of client service provided; how helpful internal audit has been in the provision of its reports, advice and recommendations; ensuring the quality of the advice and recommendations is of a high standard; user regard for the advice and expertise provided by internal audit; the extent to which internal audit

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concentrates on the areas of highest risk; and the level of assurance internal audit provided to management and the CEO/Board as to the adequacy of the agency's control structure.

Effective performance measurement mechanisms alert Chief Audit Executives and the audit committee to areas where performance targets or benchmarks are not being met, prompting them to take action to change operations and practices so that they can be effectively met in the future. Effective performance management is therefore crucial if internal audit operations are going to survive and continue to meet current and future challenges. It is therefore disappointing that just on 40 per cent of APS agencies surveyed reported that performance indicators had either a moderate or significant influence on the management and direction of the internal audit function. However, at least 84 per cent of those agencies indicated there was scope for improvement. As well, the GAIN survey indicated that there is considerable scope for the APS auditors to add more value to their work. The auditees rated internal audit's performance on average at 3.5 out of a possible score of 5, whereas the average score for non-APS benchmarking group was 4 out of 5.

Performance Feedback

Another way that internal audit can obtain feedback on their performance is to survey their clients, that is, the CEO, management and the audit committee. Our GAIN survey responses found this is a reasonably common practice in agencies outside the APS but it only tends to occur in the larger APS agencies where internal audit is predominantly an in-house operation. Even then, they are only undertaken informally and little is done with the results.

Performance feedback is a necessary mechanism for all internal auditors to gauge the effectiveness of the service provided by internal audit to auditees, to the audit committee and management. It is particularly useful for those agencies that outsource most or all their internal audit operations. Contractors will often spend much less time in the organisation and have a far more distant relationship with management in the agency than would 'in-house' internal audit staff. It seems to me that that best practice would be for the audit committee, in conjunction with the partners and chief internal auditors responsible for these operations to undertake formal client satisfaction reviews in the form of surveys on a regular basis.

This is an excellent communication vehicle which the ANAO uses following the completion of each performance audit and at the end of the financial statement audit cycle. The results of a client survey can help to cement even closer working relationships with management; can encourage internal audit

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to become more client focused; and continually improve the internal audit services provided.

The survey responses indicated there is a need for APS internal operations to improve their level of client service. Internal auditors in the APS, contractors included, need to:

- solicit management on their concerns about the agency and its operations when undertaken internal audit planning;
- address all business risks in undertaking planning;
- issue reports in a more timely manner;
- report only significant findings, and
- provide recommendations and advice that are of value to the client.

Reporting

Internal audit reports are the main product or output produced by internal audit, therefore the credibility of much of the internal audit function hinges on getting reporting right.

Our GAIN survey results indicated that APS internal audit reporting and the reporting process is generally of a high standard and rated better than their benchmarking counterparts. Most reports address weaknesses and strengths, include efficiency and economy recommendations, and offer opinions and ratings. However, the APS reports tended to be almost twice as long as their counterparts in the benchmarking groups and take 30 per cent longer to issue after completion of field work. As well, fewer internal audit recommendations are implemented by management in the APS than elsewhere. The benchmarking study also found that APS internal auditors could also work a little more closely with the auditees in preparing reports particularly where internal audit contractors are involved.

APS audit committees and managers should be reassured that the standard of internal audit reporting, when compared to those prepared by non-APS agencies, is satisfactory. However, attention needs to be given to the final production of reports to ensure they are shorter; include key recommendations; are well presented; and issued as early as possible to management. APS internal auditors and managers need to work more closely together to ensure audit recommendations are of value to management so that they will be more readily and more often accepted and adopted.

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Marketing internal audit

The GAIN survey results indicated that management did not, in many cases, highly value the services provided by internal audit. In this era of continued outsourcing and downsizing, internal audit needs to raise their profile if they are to survive. They need to more proactively **sell** their services (contractors included) to their clients, these being both the CEO and agency management. To do this they must ensure their presentation and quality of services are rated and valued highly.

Promotional flyers and brochures can help raise internal audit's profile, ensure a consistent understanding of its role, and market the services and the benefits which can be realised by the agency from internal audit. Marketing is becoming common practice in larger non-APS agencies. Centrelink has followed this lead and has released a good example for APS agencies to follow. For the smaller internal audit cells a brief flyer could be more appropriate.

In addition to these marketing efforts, the internal auditor can promote the value of audit services to management by:

- presenting well, be articulate, confident and professionally prepared including well designed business cards;
- being well qualified, trained and, have relevant experience with a good understanding of the client, the organisational culture and its operations;
- building a relationship with management, the CEO and audit committee, by meeting with them frequently and often informally whilst still maintaining independence;
- listening to management and understand their operational needs and priorities;
- gaining the active support of senior management, the audit committee and the CEO;
- undertaking reviews in areas of highest risk and of highest importance to management;
- providing management with timely reports that are relevant, include findings of importance or substance, contain detailed recommendations of how to rectify or overcome problems and are written in a constructive tone;
- expanding the range of services provided to cover evaluation and areas often associated with management consulting; and
- keeping in mind at all times that their role is to protect the CEO by providing assurance on the reliability and adequacy of operating systems

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and controls and by assisting management to improve operational performance.

The ANAO's recent benchmarking study indicated that internal audit in the APS is performing relatively well when compared to other similar organisations. However, there are areas where they are lagging behind, notably in providing a value added service to management. This and other areas discussed earlier will need to be addressed to ensure that internal audit is to make a difference to your organisation and survive. I will add that this applies just as much to the contract auditors as it does to the public servants involved.

Internal audit's relationship with the Audit Committee

The public sector audit committee is a key management tool in achieving effective control structures and an important element of corporate governance within an agency. This has been recognised in the new financial management legislation which requires all public sector entities to establish an audit committee.

The role of the audit committee is to assist the CEO with its governance responsibilities, in particular financial reporting, maintaining an efficient system of internal controls, and reviewing specific matters that may arise from the external audit process. The audit committee is also an integral part of an effective internal audit operation. The audit committee's effectiveness depends a lot on the professionalism and contribution of the internal audit function. Internal audit and the audit committee need to develop a mutual trust and confidence and a clear understanding of each other's roles and functions. In short, a partnership should be established, between the audit committee and internal audit, which would I hope extend to include external audit.

In overseeing internal audit the audit committee should ensure that the function is appropriately resourced. In doing so they should actively participate in the selection of the head of the internal audit function and should seek assurances that the qualifications, and skills sets of internal audit staff (in-house or contractors) are commensurate with the agreed strategic direction.

This may involve decisions about partial or full outsourcing of the internal audit function, probably more so in small agencies. However, in larger agencies where recruitment, skills development and retention are not as significant an issue, committees would need to give weight to other factors such as knowledge and understanding of the business/functions and a real sense of ownership, commitment and, not least, loyalty to the agency and to

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serving the public. In any event contracted auditors should ensure they have a good understanding of the agency's business and of the public sector environment and the ways in which the latter is changing if they are to provide a useful internal audit service.

As part of their annual review of internal audit the audit committee would want to be assured that the quality control mechanisms established for internal audit work have been followed. In this regard the committee may wish to consult with the external auditor and seek our views on particular aspects of internal audit. The ANAO management reports for financial statement audits include comments as to the extent to which the external audit has been able to rely on the work of the internal audit in accordance with the anticipated level of planned reliance. Such an assessment is required under the auditing standards.

The audit committee's specific responsibilities in relation to this role should be to:

- review and endorse the internal audit charter;
- take an active role in the appointment of the Chief Internal Auditor;
- make final informed recommendations on internal audit staffing requirements and if they should be provided in-house, by contractors or by a mix of both;
- endorse the internal audit strategic plan and annual work program and monitor progress against the plan;
- oversee the internal audit function and its liaison with the external auditor and management;
- review internal audit reports and monitor and critique management's responses to findings and the extent to which recommendations are implemented;
- oversee the agency's overall legislative compliance;
- approve the internal audit charter, 3 year strategic plans and annual audit work program;
- monitor the effectiveness of the internal audit function; and
- monitor the agency's progress in adopting the government's legislative reform package.

For more information, refer to ANAO's Better Practice Guide '*Audit Committees*' issued in July 1997.(#28)

Establishing a Complementary Relationship with the External Auditor

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The ANAO is keen to continue our strong partnering role with internal audit, it is crucial to achieving good corporate governance. 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 organisation's business and the manner in which it operates, such as maintaining a comprehensive understanding of the organisation's 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. 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 coordination 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.

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 coordinated 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 our audits of Financial Controls and Administration and our audits of Assurance and Control Assessment (ACA) which will leverage off the financial statement audits to a large extent.

Using Information Technology for Strategic Advantage

Information technology (IT) in its broadest sense as having a fundamental impact on our business(#29) . 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 quality and usefulness of information are pre-conditions of good decision-making. The information that any organisation has to be recognised as one of its major assets. The proper management of this resource can provide it with a significant strategic advantage, as was highlighted in the GAIN benchmarking results. Once again, this is an opportunity for internal audit to add value to

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an agency through the assurance processes based on its knowledge and skills.

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.

Internal audit needs to keep abreast of the availability of IT 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 the main challenges 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.

V. 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, particularly in the sense of being able to provide objective assessments. 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 new legislative requirements. Such a role is highly valued. But this should not be your only horizon.

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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 new Audit, FMA and CAC Acts 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 considering the recommendations in *'beyond bean counting'* which suggest agencies need to raise the profile of financial management, with the growing use of commercial approaches and practices in agencies, with a greater emphasis on contract management and quality service delivery and the requirement for managers to be accountable and manage their operations including budgeting based on accrual information. But nobody is necessarily going to issue an invitation to participate in such developments. It is up to internal audit to take the initiative, look to the future and reinvent their role so they can control their future before someone else is given the opportunity to do so. As auditors we need to learn how best to market what we have to offer, remembering that there is no substitute for performance and results.

We can derive some confidence from the GAIN survey which can only be improved by greater participation. Not surprisingly, the survey points to areas where we can improve as well as providing descriptions of successful practices that can be adopted or adapted to the particular requirements of an agency. There is no doubt scope for more risk-based auditing which should get us out of detailed checking of processes and more into assessment of the systems, particularly I.T. based, by which an agency is managed as well as determining and reporting on its performance. I also have no doubt that internal audit can contribute greatly to agency risk analysis and risk management approaches.

The disciplines and skills that need to be applied to credible control structures are endemic to audit practices. Sound control structures are essential for proper accountability and to ensure that the performance targets and indicators are achieved. That is, the former is the means to achieve the latter ends. From a management viewpoint, and indeed from the viewpoint of all stakeholders, the demand is for assurance. That can be provided in concert with the agency's audit committee where a genuine partnership relationship should be a common aim.

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 to overall public administration. We can make the one audit approach a reality where there is

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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. I hope that your deliberations during this conference will lead to further discussions and interactions on these issues when you get back to your offices.

In terms of the future of the public service we can take a degree of assurance from the Prime Minister's Garran Oration last year:

'No government 'owns' the public service. It must remain a national asset that services the national interest, adding value to the directions set by the government of the day. The responsibility of any government must be to pass on to its successors a public service which is better able to meet the challenges of its time than the one it inherited.'(#30)

We could apply the same discipline to the audit function.

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