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**Enhancing Audit Quality in a
Supreme Audit Institution**

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Introduction

In keeping with the theme of this ASOSAI Symposium “Assimilating the International Standards of Supreme Audit Institutions”, my presentation is concerned with enhancing audit quality and some of the challenges this presents for my organisation, the Australian National Audit Office (ANAO), particularly in the face of an increasingly complex world and changing stakeholder expectations.

Audit quality is never far from my mind so I am pleased to have the opportunity to speak on this topic today.

The Australian context

The office of Australian Auditor-General and the ANAO are established under legislation to audit the Australian Government public sector and, in specified circumstances, the partners who work with the Australian Government to achieve the Government’s outcomes. The independence of the Auditor-General is guaranteed in a number of ways in that legislation, with associated powers to obtain access to information and premises, and the authority to report to the Parliament on audits undertaken, or on any other matter.

My legislation requires me to set standards for the conduct of my audits. As a matter of policy, I adopt the standards made by the Australian Auditing and Assurance Standards Board (AUASB).¹ The standards made by the AUASB follow very closely the standards made by the International Auditing and Assurance Standards Board (IAASB), including those for assurance engagements. The AUASB, as did its predecessor (which was established by the accounting profession in Australia), has always had members drawn from both the private and the public sectors.

This sector-neutral approach has proven worthwhile, particularly in relation to our financial statements audit program. It means that the users of my auditor’s reports can expect the same high standards from my audits that they associate with the audit reports of listed companies in Australia, and they read reports that are presented in very similar ways.

¹ The AUASB was established by law in 2004 to make standards for both the audits of financial statements of companies and audits for other purposes.

The Financial Audit Guidelines (ISSAIs 1000-2999)

The foresight of the Professional Standards Committee of International Organization of Supreme Audit Institutions (INTOSAI) to enter into a Memorandum of Understanding with the IAASB in May 2006 to assist the development of the Financial Audit Guidelines, now forming part of the INTOSAI suite of standards, is to be acknowledged and warmly endorsed. I know from my own experience, as a member of the IAASB for 6 years through the period of the development of the clarity International Standards on Auditing (ISAs), the valuable contribution made to the process by the INTOSAI representatives on the various IAASB task forces. The inclusion of ‘public sector considerations’ in the explanatory material in each ISA, and the creation of the Financial Audit Guidelines by prefacing Practice Notes to the ISAs, emphasise the common ground between financial statements auditing in the private and public sectors.

The differences are important too, of course - there is an expectation from the Parliament that I will report on circumstances where compliance with Parliamentary authority to spend has not been met and I do this as part of my reports on the financial statements, as required.

With the release of the Financial Audit Guidelines, we have been reviewing the Practice Notes for insights into best practice for the audit of public sector financial statements to complement our own existing policies and practices. The Guidelines are informing our approach by confirming some of the things we already do and suggesting additional matters we should more explicitly take into account in our policies and in conducting our financial statement audits.

We have found confirmation of a number of approaches we already take. For example:

- Meeting a general expectation to report any non-compliance in spending, which I noted above, even though there is no express provision in legislation for me to do so;²

² ISSAI 1250 *Consideration of Laws and Regulations in an Audit of Financial Statements*, at paragraph P4 states ... “However, even where there are no such additional objectives, there may be general public expectations in regard to public sector auditors’ reporting of non-compliance with authorities. Therefore, public sector auditors keep such expectations in mind, and are alert to instances of non-compliance.”

- In assessing risks of misreporting, giving consideration to the pressures faced by government to achieve a particular budget outcome and the flow-on effect of this on reporting by component agencies;³
- Setting levels (“clearly trivial” levels) above which we report errors to agencies at amounts which are considerably below those that we understand our private sector colleagues might apply; and
- Consulting with and, where appropriate, relying upon the work of our performance auditors in the audit of an agency’s financial statements.⁴

We are also considering aspects of the guidance contained in the Practice Notes which we might conveniently add to the guidance in our standard electronic files and templates. One such example is the list of additional fraud risk factors for public sector entities in ISSAI 1240.

A story about audit quality

The Financial Audit Guidelines are a global resource for SAIs that will enhance the quality and effectiveness of public sector audits. It is important that our audit approaches be well informed so as to deliver quality audits.

I have never forgotten a story about Enron, which appears in the book "The Smartest Guys in the Room" by Bethany McLean and Peter Elkind,⁵ to underline the importance of the quality of auditing standards, and audit performance.

In the book, a former Enron accountant admits:

"We tried to aggressively use the literature to our advantage. ... All the rules create all these opportunities. We got to where we did because we exploited that weakness".

³ In ISSAI 1240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, paragraph P5 notes a fraud risk in “... tough economic conditions where there is pressure to maintain user charges and tax rates, [which may result] in incentives to overstate revenues and understate expenditures”.

⁴ ISSAI 1250 paragraph P9

⁵ Ivey Business Journal, November/December 2004, quoting from *The Smartest Guys in the Room* by Bethany McLean and Peter Elkind (Portfolio, 2003).

Another former employee described the process as follows:

"Say you have a dog, but you need to create a duck on the financial statements. Fortunately, there are specific accounting rules for what constitutes a duck: yellow feet, white covering, orange beak. So you take the dog and paint its feet yellow and its fur white and you paste an orange plastic beak on its nose, and then you say to your accountants, 'This is a duck! Don't you agree that it's a duck?' And the accountants say, 'Yes, according to the rules, this is a duck.' Everybody knows that it's a dog, not a duck, but that doesn't matter, because you've met the rules for calling it a duck."

This story carries a salutary message for accountants and auditors, and underlines why it is important to have high quality standards that have been developed in the public interest which have regard to the substance, rather than the form, of transactions and events. Much has been done, internationally and nationally, to strengthen the body of standards since the Enron era at the start of the previous decade.

Drivers of audit quality

The pursuit of quality in audit work is a constant journey for all auditors and all audit organisations.

SAIs have done a lot of work in this area. I note in particular the ASOSAI – IDI Handbook *Quality Assurance in Financial Auditing* released in 2009 and the EUROSAI publication *Achieving Audit Quality – Good Practices in Managing Quality within SAIs* released in late 2010.

In Australia, we adhere to the auditing standard for quality control within the organisation (as with ISSAI 40 *Quality Control for SAIs*, which closely follows ISQC1).

Much has been said and written about the drivers of audit quality. It seems to be generally agreed that the drivers within the control of the audit practice are broadly around:

- the culture within the practice;
- the skills and personal qualities of audit executives and staff;
- the effectiveness of the audit process; and
- the reliability and usefulness of audit reporting.⁶

The Culture within the audit practice

With the Enron story as backdrop, it is important to mention one factor that is most influential to determining the culture within an audit institution - the 'tone at the top'.

In this context, the 'Panel on Audit Effectiveness', which reported in 2000 in the US in response to a request by the Securities and Exchange Commission, wrote the following concerning professional leadership and the tone at the top:

“The “tone at the top” of an audit firm is a major influence on its culture. The Panel called on audit firms to “reaffirm, within their organisations and to the outside world, the importance of their audit practices and to stimulate their auditors to proudly hold high the banner of objectivity, independence, professional scepticism and accountability to the public by performing quality audit work.”⁷

I might mention some of the ways we address this in my Office.

Firstly, I see it as being important for me to underline just how critical it is for our standing as an office, and our stakeholders, for my office to undertake quality audits.

My office also accepts the need for our staff to be fully conversant with the requirements of the auditing standards. In the case of our financial audit staff, we have regular 'technical update' sessions to keep them up to date on developments in financial reporting and auditing standards and their application, in addition to providing more focussed topic-specific courses

⁶ UK Financial Reporting Council, *The Audit Quality Framework*, February 2008. The document was written to assist, among others, stakeholders to evaluate the policies and actions taken by audit firms to ensure that high quality audits are performed, and regulators, when undertaking and reporting on their monitoring of the audit profession.

⁷ Public Oversight Board, Panel on Audit Effectiveness *Report and Recommendations*, August 31, 2000

for staff at different levels of experience. Similarly, performance auditors have regular updates on developments affecting our audits of government programs.

While my Deputy and I have a good sense of how the organisation is performing from a quality perspective from our day-to-day involvement in audits, we have formal annual reporting procedures to our Executive Board of Management. Thus, the responsibility of Group Executive Directors for quality includes reporting against policies in relation to, for example:

- (a) the conclusions drawn from our audit file inspections, and the actions taken or proposed to resolve deficiencies identified;
- (b) achievement of Continuing Professional Development hours;
- (c) time charged, including time charged to audits, against budget and against standard hours.
- (d) rotation of Signing Officers, Engagement Executives and Quality Review Executives in accordance with the ANAO independence policy, and of Contractor partners and Quality Reviewers;
- (e) the nature and extent of other services provided by ANAO audit contractors to agencies;
- (f) an executive summary of any complaints and allegations made, and their resolution; and
- (g) acceptance and continuation of audits and audit-related services undertaken by arrangement.

We also have an Audit Committee chaired by an independent external member and an outsourced internal audit function.

Self-monitoring, however valuable internally, will rarely satisfy the demands of public accountability. For this reason, my legislation provides for the appointment of an independent auditor of the ANAO who conducts the annual audit of our financial statements and performance audits of my Office, having regard to the audit priorities of the Parliament as expressed by the Joint Committee of Public Accounts and Audit.

Skills and personal qualities

We in the ANAO have devoted a lot of time and effort to ensuring that we have sound recruitment practices and that all our audit personnel receive detailed training in the changes to our work resulting from the enhanced standards. We have coupled this with a major upgrade to our financial statement audit methodology software to give us the best possible start in applying the changed standards.

The continuing professional development of our people is one of the key aspects of our quality framework, and we work hard on improving the quality of our work, year on year. We invest heavily in the professional development of our staff, particularly recognising the public sector environment, professional standards and our own systems are constantly changing. On average, our audit staff undertake in excess of 40 hours of professional development activity each year on subjects ranging from technical matters through to management and personal development activities.

Nevertheless, some of our feedback suggests that the content and timing of our professional development programs is an area that we can improve.

We also need to be very aware of issues that impact public administration generally.

In planning and undertaking our work, relationship management is important. In addition to liaising with agencies, I am conscious of the need to improve our engagement with the accounting and auditing profession, as well as key public sector groups. It is only by doing this that we remain aware of, and understand, the contemporary issues that impact public administration which, in turn, will assist in the development of our forward work program.

Our goal is to have the staff of my Office having a ‘worldly’ understanding of the environment they audit in, complemented by sound technical skills in public sector management, accounting and auditing so that we can provide balanced reports with real insights into the issues affecting public sector administration or the fair presentation of financial reports.

Effectiveness of the audit process

There are of course many ways to enhance the effectiveness of the audit process itself.

One fundamental way is to set up, maintain and communicate a manual of audit policies and procedures. Such a document not only builds up the practical steps needed to give effect to the quality requirements of ISQC 1 and ISSAI 40; it also preserves the learnings from policy issues that inevitably arise in the conduct of audits. Maintaining such a manual is a demanding task which can get lost in the midst of apparently more pressing demands in auditing. Neglect here can come at a considerable cost.

We have for many years invested heavily in audit software for financial statements audits which has embedded within it our audit methodology. For the last few years we have employed a methodology developed in conjunction with PricewaterhouseCoopers that sits on TeamMate audit software. We maintain a “map” of each requirement in the auditing standards to the relevant procedure on the standard TeamMate file. In using a big 4 firm to help us develop and maintain our methodology, we obtain the benefits of their international audit expertise; in using a standard software product, we avoid the costs and risks of developing and maintaining our own.

We remain very aware of our responsibilities as the independent auditor of government and have developed audit programs for areas that are particular to government. At the commencement of my term as Auditor-General, a number of performance audits had been, or were, in the process of being undertaken into quite widespread non-compliance by agencies with aspects of the legislated appropriations framework. Since then, coverage of this important area has been a constant in our financial statements audit work, and, as I mentioned previously, a basis for additional reporting when the occasion arises.

We contract private sector firms to conduct some of our financial statements audits on our behalf. We do this partly as a risk mitigation exercise, where we may not have the necessary specialist industry expertise and, sometimes, when we cannot get sufficient resources, especially at the peak workload time immediately after financial year end. While we allow firms to apply their own methodology (a safe proposition because both of us follow Australian standards), our contracts provide that firms must adhere to any ANAO policies

and undertake any ANAO audit procedures that we notify them of. Notification takes place via access to a secure part of our ANAO website. Policies that we require compliance with include our materiality parameters and our appropriations audit program, as well as our audit program in relation to controls over the risk of bribery of foreign of public officials.

An important part of maintaining quality in our audits is our annual inspection of a selection of audits, both financial and performance. We review the work of each Senior Executive responsible for audits at least once in every three years. To help avoid the risk of insularity in this work, we engage external reviewers where we can. Thus we have had a partner from one of the big 4 audit firms who has Quality Review experience to examine files for audits of financial statements conducted by our staff. For the audits that we contract out to private firms, the file inspections are done by our Professional Services Branch staff. I ought to mention that I have not delegated the signing of the auditor's report for audits we contract out; accordingly, our quality reviews of these audits include examination of both the contractors' files and our Signing Officers' performance.

In respect of the quality reviews of our performance audits, in addition to our internal annual file inspections, we have an arrangement with the New Zealand Auditor-General whereby we review a small number of each others' performance audits in alternate years.

Consultation on contentious matters is a key consideration in getting our auditor's reports right. When a matter arises which may result in an audit report on a financial statement departing from our standard 'clear' report, the matter is referred to our Qualifications and Accounting Policy Committee for consideration. The Committee examines the analysis underpinning the proposed approach of the Signing Officer to the matter, against the requirements of both financial reporting and auditing standards. The Committee comprises my Deputy, the relevant Group Executive Directors, the Executive in charge of the Whole of Government audit and the Head of our Professional Services Branch.

In our performance audits, our legislation requires us to provide agencies with a formal draft report for their comment within 28 days, and for agency comments to be included in our final report. Our internal consultations are most prevalent in the preparation of issues papers which we send to the agency in advance of the formal draft report, and again in the preparation of the final report to the Parliament. My Deputy and I are heavily involved in the finalisation of

performance audit reports, together with the relevant Group Executive responsible for the audit.

The reliability and usefulness of audit reporting

An issue facing all SAIs is a need to ensure our work is relevant and meets the evolving needs and expectations of stake holders. This requires us to periodically review how we conduct our audits and review the presentation of our products, particularly our performance audit reports, taking account of feedback we receive.

Our performance audit reports are generally well-received and regarded as authoritative. Nevertheless, how we best convey our audit findings and conclusions remains an ongoing issue for us. Only a small proportion of our audits find significant shortcomings in administration – generally they identify aspects of an agency’s performance that are satisfactory, as well as areas that do warrant improvement. We therefore need to achieve a balance between ensuring our findings and conclusions are clear and focus on matters that need to be improved while, at the same time, acknowledging the positive aspects identified. Some recent feedback from a parliamentary survey suggests that we still have work to do to get our messages clear and concise - this is a constant challenge given the complexity of some of the topics we audit in the 50+ performance audit reports we table each year.

You will also be aware that the usefulness of the current audit reporting model for financial statements is under scrutiny in the wake of the global financial crisis. Questions naturally arise about the value of auditors’ report when companies make significant write-downs of assets soon after receiving clear auditor reports on their financial statements. Could auditors be providing more useful information to users rather than a simple pass/fail on the statements? We will no doubt hear more about auditor reporting on financial statements in the years ahead.

My Office’s auditors’ reports on financial statements follow the standard model, expressing an opinion on the truth and fairness of accounts prepared in accordance with legislated Finance Minister’s Orders and Australian Accounting Standards. We also draw attention in those reports to situations where agencies have not complied with statutory requirements for the spending of public moneys.

In order to enhance the value of our financial statements audit work in Australian Government entities, I provide two reports every year to the Parliament on issues arising from those audits, including how entities plan to respond. We employ a straightforward system of categorising the significance of our findings in these reports, to which entities are very sensitive. Despite this, these reports tend to have a lower profile and we are constantly challenged to improve the value of our reporting here, as the maturity of entity systems and approaches means there are fewer issues of significance than in years gone by.

Concluding comments

I am pleased with the results of the quality systems we have built into the policies and practices of the Office over the years. The results show not only in the individual audits we undertake but in the standing of the Office in the public sector community and in the wider community. We have a solid reputation for being independent and objective, and our work is not contested. But the challenge this creates for us is to do even better, to ‘lift the bar’ - and it is our focus on quality approaches that provides the platform for our performance next year, and the years ahead.

An indicator of the confidence of the Parliament in our work, and in recognition of the evolution of public administration over the last 10-15 years, late last year the Australian Parliament passed a number of significant amendments to our Act. These include the explicit authority to conduct audits of performance indicators, and an extension of our performance audit powers to allow us to assess the performance of the recipients of Commonwealth funding, including state government jurisdictions and contractors (“Commonwealth partners”).⁸

These amendments reflect the Parliament’s and the Government’s desire for a strengthening of the accountability regime, particularly in relation to the substantial amounts of money provided by the Commonwealth Government to our states and territories, as well as the extensive use of contractors by Commonwealth agencies in delivering government programs.

⁸ An audit involving a state or territory government can only be undertaken at the request of the Joint Committee of Public Accounts and Audit (JCPAA).

The other area we continue to focus on is the timing of the tabling of our performance audits. Ideally, these should be spread evenly throughout the year to assist in our own management of the work program but also to facilitate their review by the JCPAA and other Parliamentary committees. We can do better here, including by shortening the time frame for the completion of some of our audits.

We are fortunate in ASOSAI, and in INTOSAI, that we have concurrence on an integrated set of professional standards which build on the highest level international standards. The ISSAIs and the International Standards on Auditing provide us with the foundation for quality audits. As the Heads of Supreme Audit Institutions, we have a personal role in providing the ‘tone at the top’ and the audit policies and practices to ensure our institutions deliver quality work.

Delivering quality audit services is a journey that never ends. It is a journey that relies on the mutual support of SAIs and the individual efforts of each of us.