

The Auditor-General

Internal Audit

Australian National Audit Office

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28 May 1998

Dear Madam President

Dear Mr Speaker

The Australian National Audit Office has undertaken a Financial Control and Administration audit in accordance with the authority contained in the *Auditor-General Act 1997*.

Financial control and administration audit findings are reported generically. The findings and recommendations contained in this report are not therefore necessarily attributable to any one organisation, based as they are on a range of experiences. Individual organisations are identified where they reflect better practice. The nature and delivery of these types of audits are set out in the *Financial Control and Administration Audit Charter* published in 1995.

I present this report of this audit, and the accompanying brochure, to the Parliament. The report is titled *Internal Audit*.

Yours sincerely

P. J. Barrett
Auditor-General

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

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

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Results in Brief

1. The internal audit function is generally regarded as a key review and monitoring mechanism. It is an important element of any organisations control structure and thus of its corporate governance framework.
2. To establish the effectiveness of internal audit, the ANAO examined a number of important strategic issues with the potential to impact significantly on internal audits performance such as, its relationships with management; the use of risk-focused client service strategies; the appropriate balance of skills and knowledge within internal audit units; and the use of continuous improvement processes and measurement of performance effectiveness.
3. The ANAO found that, when compared to international benchmarks, the internal audit function in the public sector is significantly behind the private sector in respect to a number of key measures.
4. The audit also found that communication between internal audit, its organisations audit committee and its other clients, required improvement in several areas, such as the relevance of the audit charter, and the institution of both formal and private meetings with the audit committee and line management.
5. Internal audit has not fully embraced a business risk-focused approach and, as such, does not always effectively address the key business risks in an organisation.
6. In relation to the qualifications of internal audit staff, the audit noted a significant improvement in the ratio of qualified to unqualified professional staff. However, the professional development policies of organisations could provide more support, both to those internal auditors with qualifications and to those seeking qualifications.
7. The audit found that a minority of internal audit units use ongoing, structured methods to obtain data for use in continuous improvement of processes. Specific attention is needed to improve report cycle times.
8. While a majority of internal audit units capture and report some useful timeliness and quality performance information, less attention is paid to the cost-effectiveness of the function itself.
9. Internal audit in the Commonwealth public sector has been one of the major service activities being affected by out-sourcing and co-sourcing. This audit found that 76 per cent of organisations studied either fully contracted out their internal audit function or complemented their in-house staff with consultants. These ratios are well in excess of international experience where in-house internal audit units predominate.

Part One

Summary

1. Summary

Background

1.1. Internal audit is an important review and monitoring function in any organisation. An effective internal audit will strengthen the internal control structure of an organisation, thereby contributing to the fulfilment of organisational objectives as part of good corporate governance.

1.2. The strength of internal audit lies in its independence, characterised by its direct reporting relationship with senior management and its lack of direct participation in day-to-day operations.

1.3. As the external auditor, the Australian National Audit Office (ANAO) takes a close interest in the activities of internal audit due to the complementary nature of our respective functions.

1.4. This is most evident in the annual financial statement audit during which the ANAO evaluates the effectiveness of internal audit in terms of assessing their contribution, if any, to the financial audit process (this is a requirement of the Australian Auditing Standards **AUS 604** *Considering the Work of Internal Auditing*)

1.5. The ANAO also periodically assesses the internal audit function from a broader perspective, for example, in terms of its overall contribution to the internal control structure of an organisation and the value it adds to management decision-making processes.

1.6. The last major review by the ANAO of the internal audit function was undertaken in the 1991-92 financial year¹.

1.7. This report revisits many of the findings from that review however, it adopts a more strategic, rather than just an operational, focus.

Objectives and criteria

1.8. The objectives of this audit were to:

- ◆ provide assurance to the Parliament on the effectiveness of internal audit operations; and
- ◆ determine whether internal audit generally operates at, or near, recognised better practice.

1.9. The criteria used to measure internal audit effectiveness were based on four principles developed as part of the audit.

1.10. These principles and criteria are discussed in detail in Appendix 1. They deal with the level of management support and authority; the use of a risk-focus to address client needs; the appropriate balance of skills and knowledge; and the use made of continuous improvement processes and measurement of performance effectiveness.

1.11. The ANAO utilised an international database maintained by the Institute of Internal Auditors in the

¹ Audit Report No. 50, 1991-92, 'Internal Audit in Selected Government Organisations', June 1992

United States - the Global Audit Information Network (GAIN) - to benchmark the audited organisations against international best practice.

1.12. The audit objectives, scope and approach are fully detailed in Appendix 2 of this Report.

Opinion

1.13. The ANAO found the internal audit function in most organisations was meeting the expectations of senior management thus fulfilling the role articulated through the internal audit charter.

1.14. On the basis of the foregoing measure the internal audit function can broadly be regarded as effective. However, when the standards of international best practice are addressed, it has to be concluded that the function in the public sector is significantly behind the private sector in respect to a number of key measures.

1.15. This opinion is formed on the basis of the findings summarised below. These findings are amplified in Chapter Two of this Report.

Findings

1.16. Based on survey responses from organisations, the audit found management support for the internal audit function, both general and specific, was not as strong as could be expected for such a fundamental component of the control environment of an organisation.

1.17. Of particular concern was the apparent lack of effective communication between a number of

heads of internal audit and their audit committees.

1.18. This finding extended to a need for improved communication between internal audit and its major audit client—line management—to ensure that internal audit focuses its activity on critical business processes and significant business risks.

1.19. In many organisations internal audit has yet to make the most effective use of other assurance mechanisms such as risk and control self-assessment, in order to move from its traditional policing role towards a more valued-added independent adviser role.

1.20. The issue of the cost-effectiveness of an entirely in-house or co-sourced internal audit function was also considered. The ANAO was unable to obtain sufficient evidence to form a conclusive opinion on this issue.

1.21. In discussions with organisations that had out-sourced the function the clear indication was that they were satisfied with the out-sourcing decision. The limited options open to small organisations are also recognised as a major consideration in the out-sourcing decision.

1.22. Based on the information in the GAIN database, it is noted that Commonwealth public sector organisations use out-sourcing of internal audit significantly more than the international benchmark experience indicates.

1.23. Finally, internal audit units need to develop a continuous improvement culture and approach, including systematic measurement and reporting of performance effectiveness.

1.24. With regard to the reporting process itself, while the content of internal audit reports exceeds relevant best practice benchmarks this outcome is diminished, in many cases, by a seeming inability to report in a timely manner.

Better practice

1.25. The ANAO observed a small number of public sector organisations exhibiting better practices in a number of key respects. These included, for example, the Australian Broadcasting Corporation (co-sourced) and the Australian Customs Service (out-sourced).

1.26. Private sector experience has seen the role of internal audit change significantly over the past few years. Internal audit has become more involved with providing assurance on, and facilitation of, other management control processes, such as control self-assessment, which operate within organisations.

1.27. More effort has been placed on building a business partner role with line management and seeking to add value through the provision of decision-support services to senior management.

1.28. To a large extent this changing role has been permitted due to the maturation of business systems and processes and the increased sophistication of corporate governance structures.

1.29. The outcome of our research into private and public sector better practices is set out in the better practice guide developed in conjunction with

this audit.

Recommendations

1.30. Chapter Two contains the detailed audit findings and recommendations which address the matters raised. These recommendations are reproduced below in summary form.

1.31. In relation to current internal audit charters it is **recommended** that:

- ◆ all organisations review and confirm the continued relevance and appropriateness of their internal audit charters; and
- ◆ the chief executive be responsible for formally approving the internal audit charter (paras 2.26 to 2.41 refer);

1.32. In relation to the head of internal audits relationship with the audit committee, it is recommended that the head of internal audit:

- ◆ attends all audit committee meetings; and
- ◆ meets privately with the audit committee (or at least the Chair of the committee) at least as frequently as the committee itself meets each year (paras 2.42 to 2.55 refer).

1.33. In relation to achieving an appropriate client and risk focus, it is recommended that internal audit:

- ◆ as part of the planning process, obtain from line management their views of the key business risks facing the organisation, and solicit their concerns and perspective on the operation of key business processes; and

- ◆ develop a systematic, formal approach to planning which demonstrates clear linkages between their business risk assessments and their strategic and operational plans (paras 2.56 to 2.72 refer).

1.34. In relation to the other assurance mechanisms, it is recommended that organisations consider the role that internal audit could take in the introduction of risk and control self-assessment techniques, as part of their overall governance arrangements (paras 2.73 to 2.82 refer)

1.35. In relation to the number and mix of internal audit resources it is recommended that:

- ◆ chief executives evaluate whether the resources they apply to the internal audit function effectively meet the risk profile of the organisation as well as complementing the other relevant review and monitoring mechanisms in place (paras 2.83 to 2.98 refer);
- ◆ organisations evaluate their professional development policies in relation to their internal audit staff profiles to ensure that the level and type of training is consistent with the long-term strategies of the internal audit unit; and
- ◆ the chief executive, in consultation with the audit committee, establishes minimum academic and professional qualifications for internal audit staff, particularly, for the head of the internal audit unit (paras 2.99 to 2.112 refer).

1.36. In relation to continuous improvement activities and measurement of internal audit

performance effectiveness, it is recommended that:

- ◆ internal audit units develop appropriate performance indicators to measure the cost-effectiveness, timeliness and quality of their services and products; and
- ◆ in-house/internal audit units adopt the use of continuous improvement tools as a means of ensuring their audit, management and administrative processes follow better practice (paras 2.113 to 2.128 refer).

1.37. In relation to reporting processes it is recommended that:

- ◆ those internal audit units with report cycle times in excess of 14 days, and in particular those in excess of 30 days, benchmark their processes against better practice organisations to determine how best to reduce their cycle times (paras 2.129 to 2.143 refer).

Part Two

Detailed Findings and Recommendations

2. Detailed Findings and Recommendations

Introduction

Previous audit coverage

2.1. The ANAO last examined the internal audit function in 1991-92². That Efficiency Audit was the second phase in a three-phase review—it was preceded by a survey undertaken in 1989 and reported in 1991, and followed by a better practice guide, published in 1993.

2.2. That audit was *not a wide review of internal audit principles, but an evaluation of internal audit practices against principles*³.

2.3. By contrast, given the significant changes in the public sector in the intervening period, this present audit has focused on current principles of best practice. The audit has sought to establish whether, and to what extent, present-day internal audit units operate in accordance with these principles.

This audit

2.4. The current audit was carried out in two parts—a survey of 49 public sector organisations, using the GAIN questionnaire; followed by a detailed review of twelve of the organisations participating in the survey.

2.5. Access to the GAIN database, comprising over 700 public and private sector internal audit organisations, has

been obtained for the next two years providing the ANAO and the surveyed organisations with a valuable source of data for ongoing benchmarking of their activities.

Public sector reform

2.6. To be relevant and useful an evaluation of the present state of the internal audit function needs to consider ongoing financial, management and organisational reforms—in particular, the impact of these reforms on the risk profiles and control frameworks of public sector organisations.

2.7. Significant reductions in government spending; down-sizing; restructuring of departments and programs, including the separation of policy and service delivery; and the trend towards out-sourcing, are manifest examples of changes currently being experienced by the public sector.

2.8. Other recent changes, perhaps less apparent but no less significant, have occurred in relation to the accountability and financial management arrangements of public sector organisations. These have been effected, in particular, by the suite of financial management legislation enacted at the beginning of this year.

2.9. An organisations strategic response to these changes will include ongoing examination of its corporate governance frameworks, including its

² op. cit., Audit Report No. 50 of 1991-92

³ ibid., p. 3

review and monitoring mechanisms, for example, in relation to its risk profile, to establish their continued appropriateness and effectiveness.

The internal audit function

2.10. The internal audit function is generally regarded as a key review and monitoring mechanism by an organisation's management.

2.11. It is more broadly defined these days, than in the past, as an appraisal activity established within an organisation as a service to the organisation.

2.12. The Institute of Internal Auditors, in its professional standards, describes the function as one which assists clients, particularly management, in the discharge of their responsibilities. The activities of an internal audit unit may include analysis and/or appraisal; and the provision of recommendations, counsel and/or information as part of its assurance functions.

2.13. The distinguishing feature of internal audit is that it is *independent* within the organisation. This is generally characterised by the organisational and reporting arrangements which apply to internal audit and by the absence of involvement of internal audit personnel in operational activities.

2.14. The functions undertaken by internal audit have traditionally focused on examining, evaluating and monitoring the adequacy and effectiveness of the *internal control*

*structure*⁴ of an organisation. In essence, the management and accounting controls which operate in relation to key business systems.

2.15. However, there is an emerging trend, particularly within the private sector, for internal audit to extend its activities and influence into areas of risk management and decision-support.

2.16. The role of the internal auditor is changing from that of a 'watchdog', policing management to ensure compliance, to that of a business partner with management, acting as an independent adviser.

2.17. The extent to which this foregoing role is appropriate for internal audit depends in large part on the maturity of the corporate governance arrangements and sophistication of the control structure as part of those arrangements within an organisation.

Audit evaluation criteria

2.18. In evaluating internal audit the ANAO has placed significant weighting on the organisational context.

2.19. The findings in the report reflect a view predicated on the corporate governance arrangements and control structures, as they currently operate, in Commonwealth organisations.

⁴ Refer to the Better Practice Guide to Effective Control, 'Controlling Performance and Outcomes', 1997 produced by the ANAO for a more detailed explanation of the control structure.

2.20. As discussed previously, the findings also relate to better practice principles. They therefore have a mainly strategic perspective.

2.21. The evaluation criteria used in the audit are, accordingly, framed against the following strategic principles:

- ◆ obtaining appropriate management support and authority;
- ◆ adopting a risk-focused approach to meet client and organisational needs;
- ◆ getting the mix of audit skills and knowledge right ; and
- ◆ seeking continuous improvements in audit and administrative processes.

2.22. These principles and the specific elements of the criteria used are outlined in Appendix 1 to this Report.

2.23. The findings in relation to each criterion are discussed separately below.

Management support

2.24. Internal audit derives credibility and authority for its functions directly from its mandate and indirectly by virtue of its close relationships with the chief executive and other senior management of an organisation.

2.25. Overall, the audit found that, while senior management expressed general support for and satisfaction with internal audit, there are indications of a lack of effective communication with internal audit and of a lack of specific support in defining and supporting its role throughout the organisation.

Internal audit charters

2.26. A formal, approved internal audit charter (or equivalent document) is the mechanism by which senior management communicates to the organisation its view of the importance it attaches to the internal audit function, the role of audit and its independence.

2.27. A comprehensive charter should include, as a minimum:

- ◆ the mission, objectives, powers and functions of internal audit;
- ◆ a statement of its independence and the source of its authority;
- ◆ reporting and accountability mechanisms; and
- ◆ organisational and administrative arrangements.

2.28. The audit found that all organisations subject to review had a charter which dealt satisfactorily with the above fundamentals.

2.29. However, the audit found the authority provided by using a formal charter had been diluted, in some cases, by lack of specific approval by the chief executive.

2.30. The responsibility of the chief executive is to establish and maintain an appropriate *internal control structure*. An effective internal audit is an important tool which enables the chief executive to monitor the performance of the control structure as part of good corporate governance and the assurance this provides to the various stakeholders.

2.31. The chief executive should

therefore directly mandate the internal audit function through approval of the internal audit charter.

2.32. In doing this, it is appropriate for the audit committee to participate in the development and review of the audit charter and to endorse it for approval.

2.33. The audit also found that several organisations had not undertaken a review of their internal audit charter for several years.

2.34. In view of the recent and ongoing significant public sector reforms, including the new legislative provisions affecting the operation of audit committees, it is considered appropriate for those organisations to revisit their charters.

2.35. It is important that charters reflect current management attitudes and approaches to assurance and control.

2.36. In discussions with the Chairs of several audit committees it was clear that management expectations of the role of internal audit did not accord either with existing charters or with the actual role being undertaken by internal audit.

2.37. This has the potential to cause confusion from both internal audit's perspective and its clients' perspective. It may also lead to unfocused internal audit activity which does not add value and undermines its perceived usefulness.

Recommendations

2.38. It is **recommended** that all organisations review and confirm the continued relevance and

appropriateness of their internal audit charters.

2.39. It is further **recommended** that the chief executive be responsible for formally approving the internal audit charter.

Implementing the recommendations

2.40. The need for and timing of the recommended review should be included within the internal audit charter. It would be appropriate for the timing of the review to coincide with the Corporate or Business planning cycle of an organisation. The appointment of a new chair of the audit committee may also be an appropriate juncture at which to initiate a review.

2.41. The review is most properly carried out by the audit committee but, importantly, should encompass input from line management.

Relationship with management

2.42. In a previous audit dealing with the operation of audit committees⁵ the ANAO found that 88 per cent of organisations with an internal audit function also had an audit committee and that these committees focused heavily on internal audit activity.

2.43. The current audit reviewed the effectiveness of the reporting and internal communication arrangements and their impact on the relationship between senior management (represented by the audit committee) and internal audit.

2.44. In the survey undertaken by the

⁵ Audit Report No. 39, 1996-97, 'Audit Committees', June 1997

ANAO, using the Institute of Internal Auditors Global Audit Information Network (GAIN), it was noted in a number of organisations that the role of internal audit, viewed by the audit committee, varied from that understood by line management. This was particularly evident in the case of internal audits role in operational auditing (the examination of processes and systems from an efficiency and/or administrative effectiveness perspective).

2.45. Whereas 90 per cent of audit committees viewed operational auditing as an important role for internal audit, only 78 per cent of line management agreed with this view.

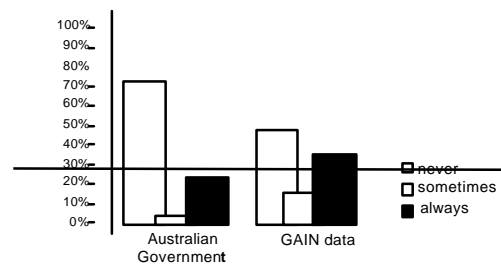
2.46. The survey responses also indicate that the chief internal auditors relationship with the audit committee could be improved.

2.47. Survey respondents indicated the majority of audit committees met four times a year or more.

2.48. However, the head of internal audit typically attended audit committee meetings in only 62 per cent of organisations. This compares unfavourably with the international benchmark of 82 per cent attendance in the GAIN universe group.

2.49. The survey results also indicated the head of internal audit was unlikely to meet with the audit committee privately 73 per cent of organisations indicating this did not happen at all. Again this compares unfavourably with the GAIN population, where 52 per cent of heads of internal audit meet privately with the audit committee at least once each year - refer Chart 1.

Chart 1 Frequency of private meetings



Source: GAIN survey

Note: the chart shows the percentage of organisations where the head of internal audit met privately with the audit committee. The frequency of meetings is expressed in relation to the number of audit committee meetings held.

2.50. Further, 28 per cent of all respondents indicated the head of internal audit neither met with the audit committee privately nor regularly attended audit committee meetings.

2.51. These results suggest that, in a significant number of organisations, the relationship between internal audit, the audit committee and line management, would benefit from increased contact. One outcome of such contact would be a better understanding by internal audit of the needs of management and of the business.

2.52. Most audit committee Chairs interviewed expressed general satisfaction with the internal audit function. However, in some cases, there was incongruence between the views expressed on the role and level of performance of internal audit, and the perception obtained by the ANAO through discussions with the head of the internal audit unit.

Recommendations

2.53. It is **recommended** that the head of internal audit attends all audit committee meetings.

2.54. It is further **recommended** that the head of internal audit meets privately with the audit committee (or at least the Chair of the committee) at least as frequently as the audit committee itself meets each year.

Implementing the recommendations

2.55. The private meetings should be taken as an opportunity to discuss the strategic direction and approach of internal audit and to communicate the committee's view of internal audit's performance.

Risk focus to meet client needs

2.56. A relevant and effective internal audit function will forge a shared vision of its role with its clients and will concentrate on agreed areas of greatest risk and on other management concerns.

2.57. To achieve these outcomes, internal audit must involve management in its planning processes. It must also ensure that its planned activities are appropriate for the *internal control structure* of the organisation, as part of the corporate governance framework.

2.58. The audit found that, while internal audit units adopted a risk-based approach to planning, it was undertaken in isolation from line management and concentrated on

financial rather than all business risks.

Planning

2.59. Internal audit's primary role is to help identify and assess business risk in an organisation. It analyses and evaluates the controls established to respond to identified risks, and reports the results to senior management.

2.60. From this perspective, internal audit planning must primarily have a risk focus. These risks should encompass not simply financial or accounting risks but all business risks which threaten the achievement of corporate objectives and program outputs and outcomes.

2.61. Such risks may relate to political, reputation, strategic or regulatory compliance issues.

2.62. The audit found that the majority of survey respondents (88 per cent) indicated they used either judgemental or quantitative risk assessment models to assist in the determination of planned audit activity.

2.63. However, in the detailed audit of selected organisations an uneven treatment of risks was observed.

2.64. It was noted that the focus of internal audit attention remains on financial and accounting risks. As a result, in these organisations, the internal audit emphasis remained with the traditional areas of reviewing controls over the processing and recording of transactions.

2.65. The linkages between internal audit's risk assessments and their strategic plans were also found to be tenuous in a number of organisations.

2.66. In such organisations there was a lack of formal documentation which related identified business risks to planned internal audit activities. Accordingly, it was difficult to establish whether the strategic and operational audit plans systematically addressed all key business risks.

2.67. It was also noted in the survey that one third of respondents indicated their risk assessments and judgements were formed without consultation with line management.

2.68. The impact of this lack of consultation revealed itself in the results of client satisfaction surveys. Where these were undertaken, the surveyed group, not surprisingly, performed below international benchmarks in relation to whether internal audit had effectively solicited management concerns.

2.69. More importantly such client dissatisfaction extended to a concern that internal audit had not addressed key business risks. This observation provides corroboration for the above finding in relation to the linkage between risks assessments and planning - refer Table 1.

Recommendations

2.70. The ANAO **recommends**, as a critical part of the planning process, that internal audit obtain from line management their views of the key business risks facing the organisation, and solicit their concerns and perspective on the operation of key business processes.

2.71. It is further **recommended** that internal audit develop a systematic, formal approach to planning which

demonstrates clear linkages between their business risk assessments and their strategic and operational plans.

Table 1 Client satisfaction ratings

	Australian Government	IIA's GAIN database
Planning		
• communicates	4.0	4.1
• solicits concerns	3.5	4.1
• covers business risks	3.5	3.9
Fieldwork		
• informs employees	4.0	4.1
• executes timely review	4.0	4.0
• uses knowledgeable	4.0	4.1
Reporting		
• issues timely reports	3.5	3.9
• provides significant	3.5	4.0
General		
• adds value	3.5	4.0
• shows courtesy / flexibility	4.0	4.4

Source: GAIN survey

Note: ratings are from 1 'Poor' to 5 'Excellent'

Implementing the recommendations

2.72. It is important for internal audit to arrive at its own, independent appraisal of these risks. However, it should consider carefully any significant disagreement between its own views and those of senior and line management. It should be able to reconcile and adequately explain these differences to the satisfaction of its clients.

Complementing the control structure

2.73. As increased emphasis is given to effective corporate governance models, senior management better understand their responsibilities within the new accountability framework. They also acknowledge that internal audit's role is one of confirmation, not ownership, of the control structure.

2.74. In organisations with mature systems, sound business processes and good governance arrangements misunderstanding of the role of internal audit is less likely to occur.

2.75. These organisations have in place a number of monitoring and review mechanisms through which the chief executive and management obtain assurance that the control structure is operating as intended.

2.76. While internal audit is an integral part of the assurance mechanism, better practice organisations will typically also utilise risk and control self-assessment processes⁶, combined with accountability sign-offs⁷ and comprehensive management reporting.

2.77. The benefits to an organisation of risk and control-self assessment include those referred to above, in particular, relating to line management ownership⁸ of the control structure.

2.78. The benefits to internal audit, which generally adopts the role of facilitator, include being able to solicit directly management concerns and perceptions of risk in a formalised setting.

2.79. This allows internal audit to focus on agreed risks and to take into account other monitoring and assurance processes when designing its own audit program.

2.80. The surveyed organisations

⁶ Risk and control self-assessments are generally structured as facilitated workshops at which senior and line management agree on business risks, the exposures arising from these risks, and the controls required, or in place, to mitigate the related exposures.

indicated that less than 30 per cent of internal audit units participated in risk and control self-assessment. This compares unfavourably with the GAIN population which is closer to 40 per cent.

2.81. This lower level of participation is also likely to reflect the low level of use of such mechanisms by Commonwealth public sector organisations.

Recommendation

2.82. It is **recommended** that organisations consider the role that internal audit could take in the introduction of risk and control self-assessment techniques, as part of their overall governance arrangements.

Internal audit resources

2.83. The relatively small size of most public sector internal audit units makes it difficult to attract and retain staff with the knowledge bases and skill sets required to provide a comprehensive, value-added auditing service.

2.84. The audit found the strategic response to this challenge by the majority of organisations was to either fully out-source, or to co-source, internal audit resources from the private sector.

Quantum and cost of resources

2.85. The total annual cost of internal audit in the surveyed organisations was \$25.8 million. This represents an

average of over \$500,000 each. By comparison, in the 1989 survey conducted by the ANAO⁷ the average annual cost (in 1989 dollars) was \$400,000 per organisation.

2.86. Eight organisations reported an annual cost in excess of \$1 million of these in excess of \$ 4 million.

2.87. As part of the audit the ANAO considered a number of measures which may be useful as benchmarks.

2.88. The measures used relate to the cost of each internal audit unit as a percentage of each organisations total expenditure and total assets; and the ratio of internal audit staff to total employees - refer Table 2.

Table 2 Resource ratio

Category	In-house	Co-sourced	Out-sourced	All
Expenditure	0.038%	0.038%	0.028%	0.030%
Assets	0.019%	0.022%	0.012%	0.020%
Employees	1:347	1:647	not available	1:560

Source: GAIN survey

Note: the relative cost of internal audit as a percentage of the total expenditure and the total assets of an organisation is lower under fully out-sourced arrangements.

2.89. While individual circumstances dictate the extent to which each measure is relevant, such benchmarks nevertheless provide a useful basis for comparison.

2.90. The data indicate those internal audit units that are out-sourced involve the use of fewer resources than those either fully provided in-house or which

use co-sourcing arrangements.

2.91. The ANAO was not able to obtain reliable estimates of the amount of staff resources used under out-sourced arrangements, or of their salary costs. It is therefore not possible to gauge whether the relatively lower level of resources used by the out-sourced group correlated to any specific factors such as lower levels of coverage or different salary costs.

2.92. The overall ratio of internal audit staff to total employees, 1 to 560, has varied little since 1989. At the time of the previous survey the overall ratio was 1 to 506.

2.93. However, there is a marked difference between co-sourced and in-house organisations. For in-house organisations the ratio is 1 to 347, which is closer to the ratios reported by the then Public Service Board in 1984⁸.

2.94. It is apparent that the general decline in employee numbers and cost reductions experienced in the public sector have not directly translated to the internal audit function.

2.95. Given the actual movement in ratios over the past nine years it would appear that internal audit staffing and total costs have gone against the general trend since 1989.

2.96. This outcome may be considered by chief executives and audit committees to be an appropriate response in a period of significant change. Greater risks may have arisen as a result of major restructuring, including down-sizing, and the re-engineering of program and service

⁷ Audit Report No. 6, 1990-91, 'Survey of Internal Audit in the Commonwealth Public Sector', September 1990

⁸ op. cit., Audit Report No. 6, p.3

delivery, often with significant information technology implications, requiring strengthening of assurance mechanisms.

Recommendation

2.97. It is **recommended** that chief executives evaluate whether the resources they apply to internal audit effectively meet the risk profile of the organisation as well as complementing the other relevant review and monitoring mechanisms in place.

Implementing the recommendation

2.98. This evaluation should, in part, take into account the cost and resource benchmarks referred to in this report.

Skill and knowledge mix

2.99. The audit considered the qualifications of internal audit staff, where employed by the organisation, and the approach being taken to professional development.

2.100. In our 1989 survey it was reported that only 43 per cent of internal audit professional staff held bachelor degrees or higher qualifications.

2.101. In the present survey this figure had increased to 73 per cent. This growth is a positive outcome indicating that organisations are cognisant of the need for appropriately qualified audit staff. The figure is also well above the international benchmark from the GAIN population which is around 45 per cent.

2.102. A counterpoint to this statistic is that only 37 per cent of surveyed organisations indicated their

head of internal audit had a bachelors degree or higher academic qualification. This compares with a rate of 81 per cent in the GAIN population.

2.103. Further, only half of the surveyed heads of internal audit held professional audit/accounting qualifications compared with 92 per cent in the general GAIN population.

2.104. Given the critical nature of this position the relatively low level of audit/accounting qualifications should be of concern to chief executives and line management.

2.105. With the exception of the key position of head of internal audit, it appears most organisations recognise the importance of having appropriately qualified internal audit staff.

2.106. However, it is noted that any such recognition does not necessarily translate fully into organisational support for continuing professional development activities.

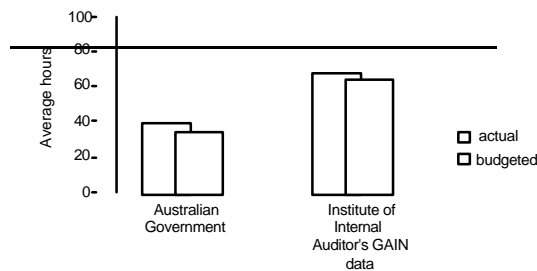
2.107. The audit found organisations are much less likely than the general GAIN population to support their existing internal audit staff obtaining appropriate qualifications.

2.108. They are also half as likely to pay for membership of professional bodies or to reimburse members of professional bodies for attendance at meetings.

2.109. Finally, training hours per auditor reported for the surveyed group averaged 40 hours per annum. While this is consistent with the

standards set down by the professional accounting bodies in Australia, it is in contrast to the GAIN population average of 67.5 hours per annum - refer Chart 2.

Chart 2 Professional development hours



Source - GAIN survey

Note: the average number of professional development hours per annum is significantly lower in the Australian public sector.

Recommendations

2.110. It is recommended that organisations evaluate their professional development policies in relation to their internal audit staff profiles to ensure that the level and type of training is consistent with the long-term strategies of the internal audit unit.

2.111. It is further recommended that the chief executive, in consultation with the audit committee, establishes minimum academic and professional qualifications for internal audit staff, particularly, for the head of the internal unit.

Implementing the recommendations

2.111. The desired academic and

professional qualifications could be included in work level standards as part of the terms and conditions of employment in each organisations certified and/or workplace agreements.

Continuous improvement

2.113. In contrast to the previous audit, with one exception discussed later, this audit did not directly examine operational matters such as the completeness and appropriateness of audit working papers; the level and extent of staff direction; or the timeliness of review and other quality control mechanisms.

2.114. To retain its predominantly strategic focus, the audit considered what continuous improvement processes were being utilised by internal audit in terms of both their audit methodologies and their management and administration of tasks and resources.

2.115. The exception referred to above related to audit reporting, which is central to the effectiveness of internal audit and is dealt with in-depth below.

2.116. The audit found that the approaches taken to continuous improvement of audit processes and measuring performance effectiveness lag significantly behind international best practices.

Continuous improvement processes

2.117. The tools and approaches available to obtain relevant data, both for measuring internal audit effectiveness and for use as inputs to continuous improvement activities,

range from client satisfaction surveys to external peer reviews, benchmarking and reporting against key performance indicators or targets.

2.118. The survey data indicated a low level of use of any of the above approaches to measuring performance effectiveness or for continuous improvement.

2.119. Less than 40 per cent of internal audit units used client satisfaction surveys, compared to their use indicated by international benchmarks of over 60 per cent.

2.120. Only 16 per cent surveyed indicated they had an external quality assurance review undertaken in the previous three years. This compares with the relevant international benchmark of slightly more than 25 per cent.

2.121. Performance indicators were used by 64 per cent of the surveyed organisations. The focus of these indicators was timeliness and quality of outputs but with little information available on cost-effectiveness.

2.122. The most often used timeliness indicators covered achievement of the approved audit program and completion of audit tasks within agreed time-frames.

2.123. The quality indicators used most often included the extent of acceptance and implementation of audit recommendations and the level of client satisfaction.

2.124. Of the 36 per cent of organisations that did not use

performance indicators, one-fifth stated they saw little value in their use and one-third had experienced difficulty developing useful indicators.

Recommendations

2.125. The ANAO **recommends** internal audit units develop appropriate performance indicators to measure the cost-effectiveness, timeliness and quality of their services and products.

2.126. It is further **recommended** that in-house internal audit units adopt the use of continuous improvement tools as a means of ensuring their audit, management and administrative processes follow better practice.

Implementing the recommendations

2.127. These performance indicators should be developed after consultation with senior management and should be endorsed by the audit committee.

2.128. The better practice guide issued by the ANAO in conjunction with this audit may be used to benchmark existing practices.

Reporting processes

2.129. The audit report is the primary communication vehicle for internal audit. The cycle time from the completion of audit fieldwork to the issue of the report is generally regarded to have a critical impact on perceptions of quality and effectiveness.

2.130. The cycle time for reporting will be affected by the approach taken to obtaining management input and feedback on

the audit findings.

2.131. All surveyed organisations indicated they issued a draft report for management review and incorporated management comments in the final report. The significant majority of organisations (92 per cent) also included an executive summary in the final report.

2.132. The ANAO view is that these are best practice approaches from the perspective that they adopt a no surprises philosophy which is more likely to receive the support of line management. Such approaches also recognise that the audit report is prepared for a number of different audiences with differing information needs.

2.133. In both the above respects the surveyed population were ahead of relevant international benchmarks.

2.134. However, there are a number of aspects of the reporting process which require attention to achieve best practice.

2.135. Foremost is the time taken to produce the final audit report. For the surveyed group the average duration was 38 days. This compares unfavourably against the international benchmark of 30 days.

2.136. Closer analysis of the results for the surveyed organisations indicated the most commonly occurring reporting duration was in the range 21 to 30 days.

2.137. In fact, the top quartile (the top 25 per cent of surveyed organisations) were able to achieve a reporting cycle time of 14 days or less.

By contrast, the bottom quartile required in excess of 50 days. Two organisations' reporting cycle times, from completion of fieldwork to the issue of a final report, were in excess of 100 days.

2.138. The better practice organisations were not correlated, for example, to either the size of the organisation, the source of internal audit resources (in-house or out-sourced), or with the percentage of the total auditing time taken for reporting (average 20 per cent).

2.139. As all surveyed organisations adopt the same approach to reporting, and given the lack of correlation referred to above, it is considered that 14 days is an appropriate benchmark for all organisations.

2.140. On this basis, 75 per cent of internal audit units fall below such a benchmark.

2.141. The impact of the lack of timeliness in reporting is observed in the results of client satisfaction surveys. Where these were used, internal audit units were rated, on average, below the international GAIN population for the timeliness of their reports.

Recommendation

2.142. It is **recommended** that those internal audit units with report cycle times in excess of 14 days, and in particular those in excess of 30 days, benchmark their processes against better practice organisations to determine how best to reduce their cycle times.

Implementing the recommendation

2.143. The effective use of technology, for example e-mail, can significantly reduce lag times for receiving and incorporating management comments and for distribution of the final report.

Canberra ACT
28 May 1998

P. J. Barrett
Auditor-General

Part Three

Appendices

Appendix 1

Better practice principles and audit criteria

The role of internal audit is changing. As organisations build more sophisticated governance frameworks it is incumbent on internal audit to adapt to the new challenges and opportunities presented by these developments.

This will require a fundamental reassessment of the strategic direction and approach of internal audit—move from its traditional policing role to more of an independent adviser.

Accordingly, the principles used for the audit and the better practice guide address the fundamentals of the internal audit practice—they provide insights into the strategic direction and focus of a modern internal audit practice.

They represent basic elements which, if not employed, will significantly hinder any attempt by an internal audit unit to re-engineer itself.

The principles developed revolve around the relationship of the internal audit unit with its key stakeholders, that is, the chief executive, audit committee and its audit clients.

They also address the planning, monitoring and review processes used by internal audit itself to ensure that its approach to auditing, and the management and administration of its own activities accord with better practice.

Each principle is outlined below. A more detailed treatment is provided in

the better practice guide which has been developed in conjunction with this audit.

Management support and authority

It is generally accepted that to be effective the internal audit function must have full support of the executive and senior management of an organisation.

In a report on Internal Audit undertaken by the Canadian Auditor-general in 1996⁹ it was observed that *probably no single factor is more important to effective internal audit than the attitude and expectations of [executive management]! That audit found a strong correlation between those departments with strong senior management support and direction and the effectiveness of the internal audit function*.

Indicators of the extent of management support reviewed in this audit included:

- ◆ the existence of a comprehensive, contemporary internal audit charter;
- ◆ reporting and administrative relationships between internal audit, the chief executive and the audit committee; and
- ◆ the extent and nature of formal and private meetings between the head of internal audit and the chief

⁹ Chapter 4, Report of the Auditor-General of Canada, May 1996.

executive and/or the chair of the audit committee.

Risk focus to meet client needs

The role of internal audit may vary between organisations depending on the particular circumstances of each.

The more traditional approach of testing for and reporting on the degree and extent of compliance with prescribed control procedures may be appropriate where an organisation has been through a period of rapid change.

In those organisations with more mature business systems, and those with sound assurance and review mechanisms established as part of their overall corporate governance arrangements, internal audit may take a more pro-active role in monitoring and reporting on systems design, evaluation and implementation activities.

Irrespective of the role determined for internal audit by the chief executive, a constant underlying principle is that internal audit should focus on critical business processes and high risk areas.

This will ensure that internal audits activities remain relevant to client needs and that its findings and recommendations are relevant to organisational success.

The audit considered the following factors in evaluating performance against this criterion:

- ◆ the nature of and extent to which independent risk assessments were undertaken by internal audit in formulating the audit plan;
- ◆ the extent and nature of involvement of executive and line management in the audit planning process; and
- ◆ the degree to which internal audit plans and activities complemented other monitoring and review assurance processes, including risk and control self-assessment.

Skills and qualifications of staff

The audit profession has clearly defined standards for the knowledge bases and skill sets required of professional auditors.

An evaluation of the competencies of internal audit resources must take these factors into account. However, the qualifications, training and background of internal audit staff will not be restricted to auditing or accounting.

The overall resources utilised for the internal audit function should reflect an appropriate mix of knowledge and skills relevant both to the context of the operations and business of each organisation, and to the role of internal audit within the organisation.

In particular, it could be expected that internal audit will seek to obtain resources with expertise in the business processes of the organisation or in business processes generally. It may also require access to specific technical knowledge and operational expertise.

These demands present a significant challenge to small internal audit units, where the particular expertise or knowledge is required only periodically.

In evaluating whether internal audit of skill and qualifications the audit considered the following:

- ◆ the remuneration and professional development policies for internal audit staff;
- ◆ the academic and professional qualifications of internal audit staff; and
- ◆ the extent and nature of contracting of specialist staff from outside or within the organisation (eg. through secondment).

Continuous improvement

Internal audit processes, both technical and administrative, in common with all other business processes, should be subject to ongoing monitoring, review and evaluation.

Perhaps the most critical process in terms of the actual and perceived quality and effectiveness of internal

had achieved the appropriate balance audit is reporting. The audit report is the primary communication vehicle. It must effectively communicate findings and present practical recommendations with realistic time frames for implementation.

In evaluating this process the audit considered:

- ◆ cycle times to produce reports; and
- ◆ the extent of acceptance and implementation of audit recommendations.

The audit also examined the other mechanisms used by the organisation and by internal audit to evaluate its performance effectiveness, including the use of client surveys, benchmarking, external reviews and the development and review of appropriate performance indicators and targets.

Appendix 2

About the audit

Background

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. The survey 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 entities which identified specific policies, procedures and practices necessary for improving the efficiency and effectiveness of internal audit. These findings culminated in the publication, in March 1993 of *A Practical Guide to Public Sector Internal Auditing*.

Five years on, and in light of considerable legislative and operational changes within the APS, the ANAO has undertaken a benchmarking study and follow-up financial control and administration audit:

- ◆ on the effectiveness of internal audit; and
- ◆ to identify public sector internal audit better practice.

Benchmarking Study

The first step involved the completion of a benchmarking study using the GAIN questionnaire. The GAIN survey was developed by the Institute of Internal Auditors as a service to its members. It is a benchmarking database of responses to detailed questions about internal audit activities, costs and methodologies from between 600 and 700 internal audit units around the world.

The ANAO supplemented the GAIN questionnaire with a number of questions specific to the requirements of the audit and provided the two questionnaires to 50 selected organisations in September 1997.

The survey respondents, 49 in total, expended \$25.7 million on Internal Audit services, for the period ended 30 June 1997.

They had total expenditures of \$68.2 billion, revenues of \$142 billion and assets of \$126 billion. They employed a total of 205,000 staff.

The survey included organisations with in-house, contracted-out (out-sourced) and mixed (co-sourced) internal audit resources.

Twelve respondents, or 24 per cent, provided a totally in-house internal audit service, seventeen respondents, or 35 per cent, relied solely on contractors for the function and the remaining

twenty, or 41 per cent, used a mix of in-house and contract resources.

Those organisations with in-house or co-sourced arrangements (29 in total) employed 355 internal audit staff, an average of 12 staff. This compares with 866 staff employed by 50 in-house organisations surveyed in 1989, an average of 17 staff.

The results of the survey were processed and compared with the results from all organisations included in the Institute's GAIN database.

A detailed analysis of the results was produced and provided, in January 1998, to all organisations who participated in the survey.

A more general Benchmarking Report analysing the overall results for the Australian Commonwealth public sector was produced in February 1998 and forwarded to all general government organisations.

The results from the benchmarking study, and the results from individual surveys, have been incorporated into this Report where appropriate.

FCA Audit

The ANAO followed the survey with a detailed FCA audit on the internal audit operations of 12 public sector organisations. The audit commenced in January 1998.

Audit Objectives

The objectives of the audit were to assess the role and effectiveness of internal audit operations in the APS and to promulgate better practice identified for the function.

Audit Evaluation Criteria

The audit sought to confirm the validity of the survey responses and undertook a more detailed review of the quality, quantity and cost effectiveness of internal audit operations.

The audit evaluated internal audit units against the following four key principles:

- ◆ obtaining appropriate management authority and support;
- ◆ adopting a risk-focused approach to meet client and organisational needs;
- ◆ getting the right mix of skills and qualifications; and
- ◆ seeking continuous improvements in audit and administrative practices.

During the audit the ANAO met with the Chairs of the Audit Committees of most of the organisations reviewed. The ANAO also met with staff from internal audit and reviewed a selection of relevant documentation against the criteria outlined above.

Performance Information

The total cost of the field work phase of the audit and production of the better practice guide is estimated to be \$455,000. The average cost of the fieldwork at each of the 12 organisations reviewed was \$15,000.

The total cost of the survey phase of the audit was \$156,000. This includes a cost of \$76,000 (US\$49,000) for the GAIN survey of 49 agencies. The survey extends over a three year period to 1998-99.

A total of 23 recommendations were made in relation to the findings arising from the fieldwork in each organisation.

Planning for the audit commenced in August 1997. The survey was undertaken in October/November 1997 and reported in January/February.

Fieldwork in selected agencies commenced in January 1998 and was completed in April 1998.

The total time elapsed from commencement of planning to tabling of the audit report was 9 months. However, this includes the benchmarking survey.

The field audit was completed in five months which is within the six month benchmark used by the ANAO as a performance measure of the timeliness of reporting FCA audits.

Series Titles

Titles published in the financial year 1997-98

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Audit Activity Report: Jan-Jun 1997
Summary of Audit Outcomes

Audit Report No.2 Performance Audit
Government Business Enterprise
Monitoring Practices
Selected Agencies

Audit Report No.3 Performance Audit
Program Evaluation in the Australian
Public Service

Audit Report No.4 Performance Audit
Service Delivery in Radio and
Telecommunications
Australian Telecommunications Authority
and Spectrum Management Agency

Audit Report No.5 Performance Audit
Performance Management of Defence
Inventory
Defence Quality Assurance (preliminary
study)

Audit Report No.6 Performance Audit
Risk Management in Commercial
Compliance
Australian Customs Service

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Australian Taxation Office

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Summary of Results and Outcomes

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*Aggregate Financial Statement
prepared by the Minister for Finance
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Year ended 30 June 1997

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Audit Report No.36 Performance Audit
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Protection of Confidential Client Data
from unauthorised Disclosure
Department of Social Security
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Audit Report No.38 Performance Audit
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