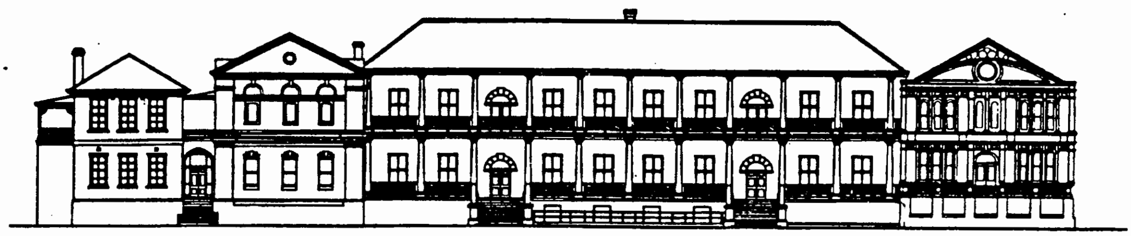
PUBLIC ACCOUNTS COMMITTEE

PARLIAMENT OF NEW SOUTH WALES

Internal Audit

in the New South Wales Public Sector



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From left: Ray Chappell (Vice-Chairman to 24 May 1993), Terry Rumble, Andrew Tink (Chairman), Ian Glachan, Geoff Irwin

The Public Accounts Committee of the 50th Parliament

The Public Accounts Committee of the 50th Parliament comprises three Government and two Opposition members. A chairman and vice-chairman are elected by the Members.

Mr Andrew Tink, BA, LLB, MP, Chairman

Before becoming Liberal Member for Eastwood in March 1988, Andrew Tink practised as a barrister in equity, commercial and shipping law. He has since served on numerous parliamentary and government committees, holding the position of Chairman of the Joint Committee on the Office of the Ombudsman prior to his appointment to the Public Accounts Committee. He is also a Temporary Chairman of Committees in the Legislative Assembly and its representative on the Macquarie University Council.

Mr Ray Chappell, MP, Vice-Chairman

Ray Chappell was elected National Party Member for Northern Tablelands in May 1987. He has worked in university administration and in the building and retail industries, and he served four terms as an alderman on Armidale City Council. Ray Chappell is the Legislative Assembly representative on the Board of Governors of the University of New England, and is a Temporary Chairman of Committees in the Legislative Assembly. He served as Vice-Chairman of the Committee until his appointment as Minister for Small Business and Regional Development on 24 May 1993.

Mr Geoff Irwin, ProdEngCert, DipTech, DipEd, MP

Geoff Irwin was elected to Parliament in March 1984 as the Labor Member for Merrylands, and he has been the Member for Fairfield since March 1988. Before entering Parliament he worked in industry as a planning and supply manager and taught business studies at TAFE. He served as a member of the Select Committee upon Small Business and as Opposition Spokesperson on Business and Consumer Affairs.

Mr Terry Rumble, ASA, MP

Terry Rumble was elected Labor Member for Illawarra in March 1988. Before entering Parliament he qualified as an accountant and was employed in public practice and in the coal mining industry. He has served as a member of the Regulation Review Committee and is the Chairman of the Opposition's Backbench Committee which involves Treasury, arts and ethnic affairs.

Mr Ian Glachan, MP

The Liberal Member for Albury since 1988, Ian Glachan has had a varied background. He served five years at sea as a marine engineer, was a farmer for ten years, and operated a newsagency in Albury for 18 years. Mr Glachan is also a past president of the Albury-Hume Rotary Club, an active member of the Anglican Church, and the Legislative Assembly member on the Board of Governors of Charles Sturt University.

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CHAIRMAN'S FOREWORD

Ineffective internal audit has been a major factor in some of the biggest corporate losses of recent years, including AWA, Tricontinental and the Victorian Economic Development Corporation.

The Public interest demands that internal audit be effective, and the Public Accounts Committee believes that there is plenty of room for improvement in New South Wales.

The Public Accounts Committee's studies of a number of New South Wales government agencies which have already made significant progress in internal control and audit matters nevertheless revealed a wide range of internal control and audit issues:

- Water Resources—tabled in Parliament an annual report which totally omitted six heavily qualified Auditor-General's opinions on financial statements.

- Health—failed in the Central Sydney Area Health Service to develop sound internal controls contributing to a $7,000,000 budget blow-out.

- Police—gave low priority to auditing police complaints and reported through an Assistant Commissioner subsequently stood aside amid allegations that some police complaints had not been properly reported.

- Roads and Traffic Authority—a report by the Auditor-General and subsequent evidence in hearings revealed strong disagreement on the importance of cost benchmarking in the internal control of the DRIVES computer project.

In addition, just this month, the Auditor-General expressed major concern about uncertainty surrounding the adequacy of the internal control environment at TAFE colleges, especially relating to non-payroll expenditure.

The legislative requirement that the Chief Executive Officer (CEO) shall establish an effective internal audit organisation *wherever practicable* is just not good enough—it should be *mandatory* with very limited exemptions and should be expanded to cover fraud control.

If CEOs take internal audit seriously, then their agencies will also. The Public Accounts Committee has therefore concentrated on CEOs accordingly.

Chief Executive Officers must be and must be seen to be the focal point of effective internal audit, and the Public Accounts Committee recommends the following:

- CEOs' internal audit responsibilities should be written into their Senior Executive Service contracts.

- CEOs must establish or contract-in effectively resourced internal audit.

- CEOs must have internal audit report directly to them, not to a deputy.

- CEOs must be involved in planning the internal audit program.

- Internal audit results for the past year and the programs for the next year must be published in the annual report to allow independent verification of effectiveness.

- CEOs must ensure internal audit has full access to all parts of the agency—no areas should be off-limits.

- CEOs must ensure internal audit is deployed in a timely fashion—information technology auditors must do their work when information systems are being planned and developed, not when they have failed.

- The NSW Treasury should encourage the creation of audit committees to provide advice to and oversight of chief executive officers on internal audit matters.

To achieve this, the Committee proposes a greater role for the NSW Treasury in:
- vetting internal audit exemptions
- oversighting internal audit reporting in annual reports
- developing and disseminating standards and guidelines on internal audit.

Whilst the Committee believes in letting the managers manage and sees internal audit as a way of allowing CEOs to police their own organisations, its inquiry has concluded that this is not alone enough. There has to be some external monitoring of the type now proposed for the NSW Treasury, and to a lesser extent the Premier's Department in matters relating to CEO contracts and Office of Public Management oversight. If this is seen as a move towards re-regulation, so be it, because the Committee believes it is also in the public interest.

More generally, neither private accountancy firms nor the Auditor-General should do both the internal and external audit of the same public sector body except on rare occasions when it is in the public interest to do so.

In an ideal world, effective internal audit would obviate the need for whistleblower legislation.

At the end of the day, however, internal control and internal audit involve the interaction of key personalities and the exercise of power in organisations as much as they involve the drafting of intricate formal requirements, rules and regulations.

Even a set of internal control and audit guidelines, standards, and regulations the size of the Sydney telephone book will not be any guarantee against the unscrupulous exercise of power.

In every case it is a question of whether or not individuals are prepared to speak up on problems. This is true of both the public and private sectors.

By this report, the Committee hopes to raise the profile of internal audit in the New South Wales public sector, and in turn strengthen public sector accountability. I would like to thank all of the Committee members for their contributions to this inquiry, which has been yet another Committee project that has received full bipartisan support. I expect that the Committee's recommendations will in turn enjoy broad parliamentary endorsement.

The Committee is grateful to all of those who have assisted with this inquiry, particularly the speakers and other participants at the seminar on internal control and audit, those who gave evidence at hearings, those who provided submissions, and those who responded to the Committee's survey on internal audit. Particular thanks go to David Worthy and Michael Jacobs of the Australian National Audit Office who travelled from Canberra to give evidence, and Mr Worthy also reviewed some aspects of the draft.

The Committee would not have been able to tackle such a specialised and complex subject as internal audit without the professional advice of John Lynas, who was seconded from the Auditor-General's Office for the project. John's depth of experience and ability to identify and research important issues have been invaluable.

Production of this report has been a model team effort by the Committee's Secretariat: Patricia Azarias directed the project, Wendy Terlecki and Caterina Sciara typed part of the draft and finalised minutes of evidence, Ian Thackeray provided administrative support, and Ian Clarke compiled and edited the report for the Committee with diligence and proficiency.

Andrew Tink, MP
Chairman
30 June 1993

EXECUTIVE SUMMARY

MAJOR FINDINGS

Internal audit is an independent and professional appraisal service to the management of an organisation to examine and evaluate the organisation's activities. The scope of internal audit should include the evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of operating performance.

It has been eight years since the Public Accounts Committee last examined internal audit. Then, internal audit had just been given legal recognition through the *Public Finance and Audit Act 1983*. Now this Act and the annual reporting legislation are under review, and it has been opportune to consider how internal audit has become established in the New South Wales public sector, and to recommend changes to further raise the profile of internal audit within agencies so that chief executive officers are better equipped to answer the increased accountability challenges of the 1990s.

The Committee has considered all of the terms of reference for the inquiry, but its findings are presented in three parts which can be thought of as concentric zones centred on the internal audit itself.

Within the agency

The centrepiece of the report, both structurally and figuratively, examines an agency management's responsibilities for internal control and internal audit, and management and board relationships with internal audit.

Management responsibility—internal control

The Public Finance and Audit Act clearly provides a responsibility for chief executive officers to establish an effective system of internal controls, including effective internal audit.

Several examples have come to light where internal controls have been neglected by management, resulting in cost overruns, financial losses, and corruption. The best private sector example is the lack of internal controls over foreign exchange dealings in AWA—a New South Wales case. In the public sector, the Roads and Traffic Authority came under the scrutiny of the ICAC when lack of controls provided an environment conducive to corruption in the issue of divers' licences. More recently, cost control in the development of the RTA's DRIVES computerised driver licensing and vehicle registration system was found by the Auditor-General to be lacking. Controls of police overtime have been reviewed by the Public Accounts Committee since 1982. And most recently, the sacking of the Agent-General in London was associated with a lack of effective internal control as detected by the Auditor-General.

Legislation needs strengthening and clarification to require chief executive officers to set in place appropriate internal controls over the whole agency, to develop more comprehensive accounting manuals, and to ensure that internal audit reviews fraud control strategies as a top priority (Recommendations 11–14). A clear way of focussing a chief executive officer on the responsibility for internal control is to make internal control a key accountability in chief executive performance agreements (Recommendation 15).

Management responsibility—internal audit

Legal backing
Internal audit is the most valuable internal control a chief executive officer can have, as it provides an appraisal of the other internal controls. The legislation provides for a chief executive officer to establish an internal audit "organisation" *wherever practicable*. This provision needs strengthening and clarification so that internal audit is *mandatory*, with specific and limited exemptions. Recommendations 16–19 seek to address this requirement.

Contracted internal audit
The merits and pitfalls of using contracted internal audit services appear to be well known. The Committee regards management of contractors as the most important issue, and the same principles of engagement and management of contract internal auditors should be used as for any other type of contractors (Recommendation 20).

The Committee recognises the merits of using wholly outsourced internal audit, wholly in-house internal audit, and combinations of outsourced and in-house internal audit, according to the nature of an agency's operations as perceived by the chief executive officer. Recommendation 21 reiterates a recommendation previously made in 1985 that the legislation should clarify that it is the responsibility of the chief executive officer to ensure that the functions of internal audit are carried out in the manner the chief executive officer believes will be most efficient and effective.

Charter
An internal audit charter which is promulgated throughout an agency is an important element of effective internal audit. This document is a clear reflection of management's attitude to internal control and audit. The Committee favoured a private sector suggestion that the charter should include a statement on internal audit capabilities, indicating how all accountability issues are addressed, and how co-ordination of total internal audit coverage is achieved where contracted internal audit services are utilised in addition to in-house services (Recommendation 22).

Scope
Internal audit has a broad scope in the public sector—much broader than in the private sector because of the greater accountability requirements of government. The Committee examined the consequences of restricting the scope of audit. The AWA case is again relevant, as well as two public sector cases in Victoria where the scope of audit was unclear.

Closer to home, the Department of Water Resources drew the Committee's attention by tabling in Parliament its annual report for 1991-92 with six sets of financial statements without the statutory Auditor-General's audit opinions. The failure to present audit opinions to back up the financial statements was indicative to the Committee of a possible internal control problem. Furthermore, the scope of internal audit in the Department apparently did not include ensuring that the financial statements were audited and reported to Parliament in compliance with normal accountability requirements applicable to the entire New South Wales public sector.

The Department of Health—the State's largest agency—has a necessarily complex internal audit structure, one arm of which was effectively strangled in a number of ways. The Central Sydney Area Health Service overspent its budget by some $7 million while trying to implement accrual accounting and develop a new accounting system. The Director of Finance appears to have restricted the scope of audit by dominating personally over the Internal Audit Manager; excluding internal audit from overseeing the implementation of the new accounting system; ensuring that internal audit was overburdened by other work; and ensuring that internal audit was not given sufficient resources to acquire information technology audit skills, either by developing skills in-house or by obtaining expertise by contracting-in.

Auditing of information system developments needs particular strengthening in the New South Wales public sector.

The Public Finance and Audit Act is too vague to be of much use in defining internal audit scope, and the expectation of a broad scope of internal audit in the public sector could be better set out in internal audit standards to be developed by the NSW Treasury (Recommendations 23 and 24).

Resources
Management's responsibility for internal audit extends to ensuring that the internal audit function is adequately resourced so that it can implement the audit plan in terms of the audit charter. That is, any in-house internal audit unit must have sufficient funds to provide the unit with the appropriate number of staff skilled in the right areas. Support for continuing education and training is especially important for internal audit, and a specific budget is required (Recommendation 25).

A chief executive officer must be careful when seconding staff to an internal audit unit from elsewhere in the agency. This may be an economical way of providing resources, but it can compromise the audit independence if a secondee is required to audit the area from which he/she came. Recommendation 26 addresses this issue.

Quality assurance
Responsibility for ensuring the quality of internal audit is shared between the chief executive officer and the manager of internal audit. The chief executive officer needs some independent assurance that the internal audit function is effective in ensuring that other internal controls are in place and that organisational targets are being achieved. The use of questionnaires to line management could be an effective means of a chief executive officer monitoring and improving audit quality (Recommendation 27).

External audit and internal audit from the same body
One of the main issues that emerged from the Committee's seminar on internal audit was "audit independence", particularly the independence of external auditors who also provide internal audit services. Concern arose from the problems of the Tricontinental group in

Victoria, whose internal and external audit were provided by the same firm of chartered accountants.

Although a professional auditing standard allows this, and it was also supported by one of the speakers at the seminar, the Committee believes it is inappropriate for the Auditor-General to generally conduct both external audit and internal audit services for the same agency. The Auditor-General supported the Committee on this matter, to the extent that the Audit Office even has a policy of prohibiting a firm contracted by the Auditor-General to conduct an external audit on his behalf from also conducting the internal audit of the same agency.

The Committee was therefore rather surprised during the inquiry when the Auditor-General was alleged to be providing internal audit and related services comprising:
- secondment of staff from the Audit Office to agencies to assist with development of internal audit functions and other internal controls
- provision of advice on internal audit and other internal controls resulting from the external audit
- extended or expanded external audit
- internal audit for the ICAC.

The Committee was satisfied that the special need for security of information in the ICAC justified the arrangement in this case, and the Committee was also satisfied with the explanations given by the Auditor-General of the other allegations. Tensions between the Internal Audit Bureau and the Auditor-General may have provoked the allegations, and Recommendation 28 attempts to encourage greater co-operation between these two auditors. Nevertheless, the Auditor-General's policy is worthy of legal backing, and Recommendation 29 addresses this.

Management and board relationships with internal audit

Importance
The Committee conducted a survey of in-house internal audit, focussing on staff size, salaries etc., to gain an impression of the importance that agency managers place on their internal audit units. The Committee also surveyed a selection of annual reports to determine whether internal audit was regarded of sufficient importance to be placed on the organisation chart (where there is at least one staff officer responsible for internal audit) and/or be mentioned in the text with regard to its achievements and problems.

Many agency managers apparently do not regard internal audit very highly at all. There are no doubt a multitude of reasons for this attitude. A simple lack of awareness of what service internal audit can provide seems, to the Committee, to be a very likely reason.

Reporting relationships
Internal audit must be professionally, administratively and clearly responsible to the chief executive officer of an agency. However, many cases were found in which a direct reporting relationship between a chief executive officer and internal audit, as required by legislation, was not apparent, and the independence of the internal audit could be compromised. In most explanations heard by the Committee, internal audit was said to be

able to directly report to the chief executive officer, but was also administratively responsible to someone else.

Surely internal audit *needs* to be administratively responsible to no position in an agency other than the chief executive officer, who is legally responsible for providing internal audit's resources.

A classic example of inappropriate reporting of internal audit was provided by the Police Service, where internal audit reports to an assistant commissioner responsible for handling complaints against police. The Police Service's audit plan places lower priority on auditing this area compared with auditing of financial matters and accountable items. Action was recently taken against two assistant commissioners for failure to properly report complaints against police, and one of these commissioners was responsible for internal audit. This was clearly not a satisfactory arrangement—internal audit should have been a *check* on the assistant commissioner's responsibilities rather than being responsible *to* the assistant commissioner.

Accountability of a chief executive officer for internal audit can be enhanced through disclosure in annual reports. In Recommendations 30–32, the Committee recommends legislative changes to require a section on internal audit in each annual report of an agency, regardless of whether the internal audit is contracted-out, in-house or a combination. The section should report on:

- the program of internal audit planned for the year under review
- the internal audit functions contracted out and conducted in-house
- major findings of the audit
- major internal audit recommendations and management's response
- problems experienced in conducting the planned audit

Most importantly, in-house internal audit units should be clearly shown to report directly to the chief executive officer.

Other ways of enhancing the independence and importance of internal audit in an agency are addressed in Recommendations 33 and 34.

Audit committees

In the private sector, audit committees have long been accepted as an effective means by which boards of directors can exercise proper control over the financial and related affairs of a business. An audit committee is a subcommittee of the board, typically comprising three to five non-executive members. It is the board's watchdog on the organisation—its channel into the organisation's operational and financial activities to obtain all of the necessary information for the board to understand the organisation.

As we emerge from the economic downturn and corporate collapses of the late 1980s, there has been an increasing call for making more and better use of audit committees in the private sector. After weighing up a considerable body of evidence on audit committees, the Public Accounts Committee concluded that a properly structured audit committee which has clear responsibilities should be a major contributor to effective internal control and good corporate governance in *any* large organisation, be it in the public or private sector. The big question, however, is should audit committees be mandatory in the New South Wales public sector, in line with mandatory private sector audit committees in Canada and the call for mandatory audit committees elsewhere?

The current requirement for audit committees through guidelines is just not strong enough. The Committee could not find any good reason why government agencies with boards of management should not be required to have independent audit committees of the private sector model. Surely one of the main *responsibilities* of a board of management should be to establish a subcommittee to oversee internal and external audit.

The Committee would also like to encourage the establishment of "executive audit committees", regardless of the existence of a management board. A model of an executive audit committee provided by Pacific Power is a good start, but agencies should not limit themselves to this particular example.

Recommendations 35-38 address the requirement for audit committees.

Beyond the agency

The first part of the report looks at factors which impact on internal audit from outside the agency, namely, the legal requirement for internal control and audit, the role of other agencies in internal audit, and internal audit standards.

Legal requirements

All evidence collected by the Committee points to the need to strengthen the general legal requirement for internal control and audit in several areas. An accountability gap was found in the area health services of the Department of Health, and it was concluded that these bodies should be brought into the direct ambit of the legislation on financial management, auditing and annual reporting relevant to the public sector generally (Recommendation 1).

Other agencies

Agency managers and internal auditors must be aware of the role of other government and independent agencies with responsibilities for public accountability, particularly in relation to internal audit. These agencies comprise the NSW Treasury, the Auditor-General, the Internal Audit Bureau, The Premier's Department, the Independent Commission Against Corruption, and the Ombudsman. The special relationship between the Auditor-General and internal audit was examined in the third part of the report.

Standards

The Committee found that there was a proliferation of standards relating to auditing. However, the preference in the NSW Treasury's internal audit guidelines for standards from only one professional body, and a complete silence on standards in the legislation, appear to provide confusing direction to internal auditors, agency management and boards of management alike.

The issue of standards is fundamental, because many other issues relevant to internal audit can be addressed through having appropriate standards. The Committee feels that internal auditors and agency managements would benefit from having clearly defined standards of internal auditing, and the government would benefit from mandatory compliance of its agencies with those standards.

Ideally, there should be a national set of standards for public sector internal auditing which can be used by all State and Commonwealth jurisdictions. Such standards should be developed by taking the best standards from all of those available from the accounting professional bodies, the auditing professional bodies, and the Australian Standards Association. Realistically, however, the Committee cannot see this happening in the near future, although that should not mean that the New South Wales Government should not pursue this goal.

In the mean time, it appears that the standards of The Institute of Internal Auditors (IIA) provide the best basis for internal auditing standards that could be applied to the New South Wales public sector. During the course of this inquiry, the Commonwealth Government released its own standards, based on the IIA's. These could be adapted by this State with a few modifications to serve as an interim measure until an agreed national set of standards was developed.

The Committee concluded that the best way to ensure compliance with internal audit standards would be to incorporate them into the Treasurer's Directions, combined with specific reference in the legislation to the new Treasurer's Directions. The NSW Treasury should also actively monitor compliance with the standards, indirectly through the Auditor-General if this is the most efficient way.

Recommendations 2-6 seek to address the need for formal internal audit standards applicable to the New South Wales public sector.

Universities
While the Committee was deliberating on using Treasurer's Directions to implement standards for internal audit, it was realised that universities are explicitly excluded from Treasurer's Directions. On the other hand, proliferation of adverse comments in Auditor-General's reports about internal control problems in universities suggests a need for considerable improvement in accountability of the huge tertiary education sector. Universities should not be exempt from Treasurer's Directions while they are administered by the New South Wales government, and Recommendation 7 addresses this.

Guidelines
With the implementation of the Committee's recommendations to formulate internal audit standards and incorporate them in Treasurer's Directions, the content and role of the NSW Treasury's guidelines on internal audit will have to be revised with greater focus on a chief executive officer's responsibilities (Recommendation 9).

The NSW Treasury therefore has a substantial task to improve the legal and supporting framework for internal audit, and could well be assisted in this by an advisory group and the Auditor-General as addressed in Recommendations 8 and 10.

Within the internal audit

The third and final part of the report focuses on the internal audit itself, namely, the responsibilities of the internal audit, and the relationship between the internal audit and the external auditor.

Internal audit responsibilities

Planning
The internal audit planning process is vital to the process of allocating resources to internal audit, and needs incorporating into NSW internal audit standards and greater attention in the internal audit guidelines. Recommendations 39 and 40 address this issue.

Reviews
Regionalisation and decentralisation of agencies, together with devolution of line management responsibilities, have increased the difficulty of providing effective internal audit. Internal reviews and external reviews are important elements of quality assurance of internal audit, particularly in such circumstances. Recommendations 41–43 address the need for internal and external reviews, including a legal requirement for three-yearly external reviews of the Internal Audit Bureau.

Competence
The Committee's survey of internal audit uncovered a wide variety of degrees, diplomas, certificates, and memberships of professional bodies among internal auditors. Very few audit staff were found not to possess or not be in the process of acquiring professional qualifications or status. The Committee is inclined to agree with the two professional bodies from which it heard evidence that membership of such bodies usually places an obligation on employees to act professionally, hold or acquire professional qualifications, and keep up-to-date with developments in their chosen field of endeavour. For the New South Wales public sector, internal audit staff *should* have evidence of or be working towards acquiring professional qualifications and related competency standards appropriate to auditing and/or the field in which the audit is being conducted (Recommendation 44).

The Committee acknowledges that New South Wales government agencies have developed different models to address competencies for internal audit. However, the lack of competency standards for internal audit and the absence of any statutory or other criteria to register or licence internal auditors is of concern. This was addressed in Recommendation 45.

Relationship between internal audit and external audit

There will probably always be some tension between internal and external auditors, as well as between external auditors and their clients. The Committee feels that such tensions could largely be eased with the use of audit committees. The Committee would like to see one of the most significant outcomes of this report being the establishment of the primary role of audit committees and executive audit committees in the New South Wales public sector as "the bringing together and co-ordination of the functions of the Auditor-General (as external auditor), the internal audit, the management of an agency, and the board of management (if one exists) to benefit the whole agency."

Conclusions

The Committee expects that some will consider many of the Committee's recommendations to be re-regulatory, while the recent public sector management trend has been towards deregulation, devolution, and risk management. After considering major losses in the private and public sectors of other jurisdictions in the 1980s, and more recent smaller scale problems in the New South Wales public sector, the Committee wonders whether this trend may have gone too far. The Committee senses that New South Wales may be on the cusp of a new phase of management reform in which we back away slightly from the current trend. In particular, the Committee believes that its emphasis in this report on the chief executive officer's responsibilities for internal control and internal audit is perfectly consistent with the concept of "letting the managers manage", but has the intention of ensuring that the managers do indeed *manage*.

LIST OF RECOMMENDATIONS

1. Financial and reporting requirements for area health services are totally inadequate. To rectify this, the Treasurer should list area health services, the Ambulance Service, and proposed country-based regional health services separately as statutory bodies in the replacement of Schedule 2 of the current Public Finance and Audit Act. (p. 25)

2. The NSW Treasury and the Auditor-General should work towards the development of national standards for public sector internal auditing by the appropriate professional bodies (The Institute of Internal Auditors-Australia, Australian Society of CPAs, Institute of Chartered Accountants Australia, and Standards Association of Australia). The standards should be general enough to cover all aspects of internal auditing, not merely auditing of financial compliance. (p. 41)

3. As an interim measure, the NSW Treasury should adapt the internal audit standards developed by the Commonwealth Government, based on those of The Institute of Internal Auditors, for application to New South Wales, ensuring consistency with this State's statutory requirements. The standards should be issued as Treasurer's Directions. (p. 41)

4. In adapting the Commonwealth internal audit standards for application to New South Wales, reference should be made to the working relationship of internal audit with the Auditor-General, the Premier's Department, the Independent Commission Against Corruption, and the Ombudsman. (p. 42)

5. Standards will achieve their objective of raising the quality of internal audit only if there is a strong requirement for compliance. The Treasurer should therefore make specific *statutory* provision for New South Wales government agencies to comply with these standards. (p. 42)

6. The Office of Financial Management of the NSW Treasury should include in its annual report a section on what it has done to ensure compliance with the internal audit standards, and an evaluation of that compliance. (p. 42)

7. Universities should not be exempt from New South Wales Treasurer's Directions while they are administered by this State. If full Commonwealth control over universities is not effected by the time the Public Finance and Audit Act is replaced, the Treasurer should remove the statutory general restriction on the Treasurer issuing a Treasurer's Direction to a university. (p. 44)

8. The NSW Treasury has a substantial task to improve the framework for internal audit in this State's public sector. To assist in this task, particularly in the development and ongoing review of internal audit standards and guidelines, the NSW Treasury should establish an advisory group comprising representatives of the professional accounting and auditing bodies, the Standards Association, the Auditor-General, and some large government agencies. (p. 45)

9. With clear internal audit standards available, the content and role of the NSW Treasury's internal audit guidelines will need revision. The NSW Treasury should issue a new booklet on guidelines for internal control and audit, focussing on a chief executive officer's responsibilities in this area. The booklet should be maintained in an up-to-date and thorough way with regard to all internal audit requirements, and should be made readily available to agencies in both paper and electronic format. (p. 45)

10. Following the statutory external audit of agencies, the Auditor-General should report to Parliament on the adequacy or otherwise of NSW Treasury standards and guidelines for internal audit, and the actual performance of internal audit in the New South Wales public sector. (p. 45)

11. Fraud and corruption prevention strategies and systems should be made a top priority for review by internal audit, and the Treasurer should therefore make specific legislative provision accordingly. (p. 55)

12. Section 11(3) of the Public Finance and Audit Act requires government agencies to prepare accounting manuals, but this requirement is too narrow. The Treasurer should amend the legislation to *expand* the requirement for an accounting manual to include manuals covering accounting policy and procedures, internal control procedures (both financial and non-financial), and internal audit. (p. 59)

13. The NSW Treasury should develop, in conjunction with professional bodies, guidelines for chief executive officers and agency management generally on items to be included in the manuals referred to in Recommendation 12. (p. 59)

14. Chief executive officers of agencies must set in place appropriate internal controls covering *all* parts and operations of their agencies, and any doubt about this should be removed by the Treasurer with appropriate amending legislation. (p. 68)

15. The performance agreements of chief executive officers should include effective internal control as a key accountability, with appropriate performance indicators and performance targets, and the Premier's Department should take all necessary steps to ensure that this is done. (p. 68)

16. The statutory requirement for a chief executive officer to establish an internal audit function *wherever practicable* must be strengthened. The requirement to establish an internal audit function should be *mandatory*, subject to specific and limited exemptions. The Treasurer should amend the legislation accordingly, including provision for a new schedule of exemptions. (p. 72)

17. There will therefore need to be criteria against which applications for exemption from internal audit can be assessed. The NSW Treasury should develop such criteria, and these should address the ability of the chief executive officer to ensure that proper systems of internal control are maintained over all operations of the authority without the need for a separate internal audit function. (p. 72)

18. The NSW Treasury should maintain the new schedule of exemptions by assessing applications by agencies for inclusion on the schedule against the exemption criteria. Where an agency satisfies the criteria, final approval for inclusion in the schedule should rest with the Treasurer. (p. 72)

19. In his annual external audit of government agencies, the Auditor-General should review those agencies on the schedule of exemptions with regard to the appropriateness of their continued listing on the schedule. Recommendations for removing agencies from the list should be made to the Treasurer. The NSW Treasury should assess such recommendations against the exemption criteria. Where an agency is determined to no longer satisfy the criteria, final approval for removing an agency from the schedule should rest with the Treasurer. (p. 72)

20. There are many advantages of contracting-in internal audit services, but internal audit contractors need to be properly engaged and managed as for any other type of contractors. The NSW Treasury should amend the guidelines on internal audit to advise that chief executive officers who contract-in internal audit services should use the Office of Public Management's *Guidelines for the Engagement and Use of Consultants* for the selection and management of those services. (p. 78)

21. There is merit in using wholly outsourced internal audit, wholly in-house internal audit, and mixtures, according to the nature of an agency's operations and the need to obtain an economical, efficient and effective service. In its 1985 report on performance review practices in the New South Wales public sector, the Public Accounts Committee made a recommendation that has not yet been implemented. That recommendation is reiterated in the current report: the Treasurer should amend the legislation to clarify that the chief executive officer is responsible for ensuring the performance of the functions outlined in s. 11(2) of the Public Finance and Audit Act, but that the organisational form of the internal audit function—that is, whether it is conducted in-house and/or contracted out—should be left to the discretion of management. (p. 80)

22. The NSW Treasury should ensure that the internal audit standards to be prepared in accordance with Recommendation 3 require the internal audit charter to include a positive statement on internal audit capabilities, indicating that all accountability issues are addressed. Where services are contracted-in, the capability statement should indicate how co-ordination of total internal audit coverage is achieved. (p. 82)

23. The internal audit standards to be developed by the NSW Treasury should include reference to the broad scope of internal audit that is appropriate to the public sector, including:
    - information technology audits,
    - efficiency and effectiveness audits,
    - compliance audits, and
    - control and prevention of fraud and corruption.

    The need for internal audit to be involved with new information technology developments from early stages should be particularly emphasised. (p. 96)

24. Internal audit should be given a free rein to examine any area that, in the professional opinion of the audit manager, warrants attention. Any evidence that comes to light on management limiting the scope of internal audit appropriate for that agency should be regarded as evidence of non-compliance with the legal requirement for a chief executive officer to establish an effective system of internal control. (p. 96)

25. Internal auditors need to continue their professional education and training on-the-job, and resources have to be made available to enable this. The NSW Treasury should amend its guidelines on internal audit to require a chief executive officer who decides to have an in-house internal audit unit to provide an explicit budget for ongoing training and education of audit staff, in line with professional requirements for internal audit. Total responsibility for the administration of that budget should be given to the manager of internal audit, and the budget should be varied only with the approval of the chief executive officer. (p. 100)

26. Internal audit independence from the operations of an agency is paramount. Conflicts of interest can arise, however, in some cases in which operational staff are seconded to internal audit. The NSW Treasury should include in the internal audit guidelines a requirement for chief executive officers to not use seconded staff in internal audit to audit the areas in the agency from where they are seconded. (p. 103)

27. Questionnaires can be useful to a chief executive officer in monitoring and improving internal audit performance. The NSW Treasury should include in the guidelines on internal audit a recommendation that the chief executive officer or the audit committee should review the quality of internal audit through questionnaires to management. (p. 104)

28. The Auditor-Generally currently seconds senior staff to agencies, at their request, to assist with establishing an effective internal audit function. With the recent establishment of the Internal Audit Bureau as a statutory authority with a role of providing internal audit services to agencies, there is a need for co-operation between the Bureau and the Auditor-General in provision of internal audit services. Before providing further staff on secondment to agencies to assist with developing the internal audit function or other internal controls, the Auditor-General should raise the matter with the Director of the Internal Audit Bureau to ascertain whether a secondment, a contracted service or other arrangement through the Bureau would be more appropriate. (p. 113)

29. In the public sector, in which a greater level of accountability is required than in the private sector, it is generally inappropriate for both the internal audit and the external audit of an agency to be conducted by the same auditor. The Treasurer should amend the legislation to prevent an agency from using both external and internal audit services from either the Auditor-General or a firm contracted by the Auditor-General, other than in exceptional circumstances (such as those relevant to the ICAC). The Treasurer should be responsible for approving such exemptions. (p. 113)

30. Many chief executive officers have failed to ensure that their internal audit units report directly to them as required by the Public Finance and Audit Act. To ensure compliance, chief executive officers should be required to specify in their agencies' annual reports diagrammatically or in the text the appropriate internal audit reporting lines, and the Treasurer should amend the legislation accordingly. (p. 119)

31. Chief executive officers should ensure that their agencies' annual reports include a section on internal audit covering:
    - the program of internal audit planned for the year under review
    - internal audit functions contracted out and conducted in-house
    - major findings of the audit and other significant matters relating to reviews of internal controls
    - major internal audit recommendations and management's response, including reasons for not implementing recommendations
    - problems experienced in conducting the planned audit, for example, impact of unscheduled work, staff turnover
    - the audit plan for the following year
    - details of exemption from internal audit if applicable.

    The Treasurer should make the necessary legislative amendment, incorporating the instruction in the Premier's Memorandum 91-3 on program evaluation, as well as the current legislative requirement to report action on significant matters raised by the Auditor-General arising from the external audit. (p. 120)

32. Compliance with annual reporting by chief executive officers of internal audit and significant matters raised by the Auditor-General should be policed by the NSW Treasury. The Auditor-General can be used to review accuracy of information. (p. 120)

33. To further strengthen the independence of internal audit from the operational parts of an agency, internal audit staff should not have any ongoing line management or other operational responsibilities within the agency. The NSW Treasury should amend the guidelines accordingly. (p. 120)

34. The internal audit section of an agency should not be used as a pool of staff to fill temporary vacancies in the agency, and so the NSW Treasury should amend the internal audit guidelines accordingly. (p. 120)

35. All boards of management of large government agencies should establish audit committees of non-executive board members, and the Treasurer should provide legislation accordingly. Such audit committees should be required to comply with a revised section on audit committees in the NSW Treasury's guidelines on internal audit. The NSW Treasury should also develop criteria for determining those agencies that warrant audit committees of boards. (p. 130)

36. The NSW Treasury should amend its guidelines on internal audit in regard to audit committees to ensure that the membership and relationships of public sector audit committees with internal and external auditors are consistent with best practice in the private sector. In particular, the audit committee should ensure liaison between the internal auditor, the external auditor, and the management of the authority. A further function is to review implementation by management of recommendations made in internal audit reports. (p. 130)

37. Large agencies should also establish "executive audit committees", and the internal audit guidelines should be amended by the NSW Treasury accordingly. The guidelines need to provide useful advice on the structure, functions and responsibilities of executive audit committees. (p. 131)

38. Ongoing parliamentary oversight of audit committees is desirable. This should be effected by the Treasurer amending the legislation to provide that, as part of the annual external audit, the Auditor-General should review the functioning of audit committees and executive audit committees, and then present his findings in the Auditor-General's reports to Parliament. This will include review of the way the committees handle internal audit matters other than financial compliance matters. (p. 131)

39. Greater assistance to chief executive officers is required for them to fully appreciate the internal audit planning process and use it to allocate resources for internal audit. The NSW Treasury should amend the internal audit guidelines to explain the detailed process required to prepare an effective plan for the conduct of the internal audit function, and to show how this planning process should be used by management to assist in determining the appropriate resources required for the internal audit function. (p. 136)

40. In the standards to be adapted in accordance with Recommendation 3, the NSW Treasury should incorporate Statement of Auditing Practice AUP10—*Planning*, suitably augmented to include the broad scope objectives of internal audit, to assist internal audit managers with the planning process. (p. 136)

41. Regionalisation and decentralisation of agencies, together with devolution of line management responsibility, have increased the difficulty of providing effective internal audit. The NSW Treasury should include in the internal audit guidelines advice on internal reviews of internal audit to agencies which have audit staff outposted to regional centres or subsidiary divisions or branches away from the main audit unit. (p. 141)

42. In developing public sector internal audit standards (see Recommendation 3), the NSW Treasury should provide for quality assurance programs, including three-yearly external reviews, in line with the internal audit standards issued by The Institute of Internal Auditors Inc. (p. 143)

43. To be consistent with statutory peer review arrangements for the Auditor-General's Office, the Internal Audit Bureau should be subject to three-yearly external reviews. The Treasurer should amend the Bureau's enabling legislation accordingly. (p. 143)

44. In recognition of the professional status of internal auditing, the NSW Treasury should amend the internal audit guidelines to require internal audit staff of in-house internal audit units to have evidence of or be working towards acquiring professional qualifications and related competency standards appropriate to auditing and/or the field in which the audit is being conducted. (p. 148)

45. The lack of competency standards for internal audit and the absence of any statutory or other criteria to register or licence internal auditors is a weakness. The NSW Treasury should develop competency standards for internal audit units in the public sector in co-operation with the Auditor-General, the Auditing Standards Board, The Institute of Internal Auditors—Australia, and relevant employee organisations. (p. 148)

INTRODUCTION

BACKGROUND TO THE INQUIRY

ROLE OF INTERNAL AUDIT

In June 1985 the Public Accounts Committee tabled a *Report on Performance Review Practices in Government Departments and Authorities.*[1] In that report particular attention was given to internal audit, which only two years previously, had for the first time received legal recognition through the *Public Finance and Audit Act 1983*.

Eight years later, internal audit has undoubedly become much more established in the New South Wales public sector. Also, reforms in public sector administration and increased requirements for accountability haveled to changes in the way agencies review their performance. Still, throughout the public sector there is an inconsistent utilisation of internal audit.

In its introduction to its standards for internal audit, The Institute of Internal Auditors Inc. (IIA) states that:

> Internal auditing is an independent appraisal function established within an organisation to examine and evaluate its activities as a service to the organisation. The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end, internal auditing furnishes them with analyses, appraisals, recommendations, counsel, and information concerning the activities reviewed.
>
> The members of the organisation assisted by internal auditing include those in management and the board. Internal auditors owe a responsibility to both, providing them with information about the adequacy and effectiveness of the organisation's system of internal control and the quality of performance.[2]

In 1985, the Public Accounts Committee found that managers in New South Wales government agencies tended to historically see the internal audit role as providing assurance of compliance with procedures and regulations, but a broader role was developing.[3]

Now, internal audit can cover a multitude of review activities which are consistent with the IIA's broad definition:
- financial compliance checks
- efficiency and effectiveness reviews of operations (operational or management audits)
- review of development and maintenance of information technology systems
- environmental audits

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1 Report No. 15.

2 The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, Florida, p. 1.

3 Public Accounts Committee, op. cit., p. 56.

- monitoring performance against objectives and targets in a corporate plan
- program evaluation
- fraud control

Some of these, it could be argued, are not strictly internal audit, and some agencies have internal audit units as well as other units called "management review", "planning and review", etc. The Committee feels that terminology in itself is unimportant, but believes that each agency should have in place controls appropriate to the operations of the agency and the risk of operations failing to provide the goods and services asked of them. Of course, those controls also need to be periodically reviewed.

For example:
- If an agency handles large amounts of cash, then those cash handling systems need checking to ensure that all of the cash received is accounted for and goes where it should.
- If an agency is involved in environmentally sensitive operations, then it has to be sure that it is complying with all environmental protection requirements, as well as taking steps to minimise environmental damage.
- An agency charging for desirable services must ensure that potential for fraud is minimised.

Internal audit therefore can require a high degree of specialisation, for example, in accounting, marketing, engineering, information systems, industrial relations, insurance and finance, and even forestry. In this report, *internal audit* is used in its broadest possible sense.

The Committee agrees with the view that internal audit should be regarded as adding value to an organisation rather than merely being a cost centre. It adds value by:
- Ensuring that internal controls are working efficiently and effectively,
- Identifying problems in internal controls,
- Recommending solutions to problems, and
- Helping to implement solutions.

INCREASED ACCOUNTABILITY CHALLENGES OF THE 1990S

Over the last ten years, the New South Wales public sector has been reshaped by a series of reforms of financial and operational management. Many of these reforms have increased the need for government agencies to be accountable to the community through the Parliament. Some of the major reforms have been:

- revised legislation providing for financial management, accounting and auditing
- legislation providing for annual reporting
- revised legislation for operational management, including provision for a chief and a senior executive service
- strategic planning, with clear objectives and target outputs and outcomes
- program and global budgeting
- performance monitoring, including development of performance indicators
- accrual accounting

- separation of policy from operational management
- net appropriation funding.

This reform process is continuing, with new banking arrangements being implemented for agencies, and a revision underway of the legislation providing for financial management, accounting, auditing and annual reporting.

Parliamentary scrutiny of the executive government is also increasing. This has particularly been the case sine the 1991 election, which resulted in the Coalition Government no longer having a clear majority in the Legislative Assembly. The balance of power currently lies with the three so-called non-aligned Independent Members.

Shortly after the formation of the 50th Parliament, the Independents entered into a memorandum of understanding with the Greiner Government. In this document, the Independent Members expressed their concern that the balance of power between the Parliament and the executive government had shifted too far in favour of the latter. The agreement is for the Independents to support the Government on appropriation bills and motions of no-confidence in the Government except where matters of corruption or gross maladministration are involved which reflect upon the conduct of the Government as a whole. In return, the Government has undertaken to implement a *Charter of Reform* containing a series of measures which the Independent Members believe would help to redress that perceived imbalance.

One of the elements of reform in the Charter is "Further refinement of a Performance Review Committee system for the Legislature to scrutinise Government departments including statutory bodies."[4] This is still under consideration, but there has been a proliferation of other parliamentary committees since the election, namely, estimates committees, select committees to scrutinise proposed legislation, and select committees to investigate aspects of certain agencies (e.g. Police Service, HomeFund and the Water Board). The Auditor-General has also been requested to carry out a special investigation on the London Office of the Agent-General, essentially because of parliamentary interest. There is now far greater opportunity for the Parliament as a whole to oversee the policies and operations of the executive government, and members of Parliament are taking advantage of that opportunity. Accordingly, the accountability of government agencies has never been greater, and this trend is unlikely to change in the foreseeable future.

After hearing many hours of evidence in hearings and working through submissions to this inquiry, the Committee feels that internal audit has much more potential to assist chief executive officers in responding to this increasing need to be accountable than is currently realised. Internal audit can provide a valuable assurance to chief executive officers that their agencies are achieving their objectives efficiently and effectively, in compliance with all legal requirements, and in accordance with government policy.

[4] op. cit., p. 5.

CORPORATE LOSSES OF THE 1980S

The decade of the 1980s saw the proliferation of business practices and attitudes which are of concern from an audit point of view, and which contributed to the collapse of major companies and the reduction in business and consumer confidence. These practices can be summarised as:

- an emphasis on expansion at the expense of caution;
- an inadequate level of scrutiny given to the means by which performance was achieved, and to performance itself;
- a low priority given by management to the maintenance of effective internal control, and compliance with policy and legislation.[5]

Whilst these attitudes were far more widespread in the private sector than in the public sector, notable examples in government were uncovered in Victoria, Western Australia and South Australia.

Internal audit in Australia has itself received a lot of media attention recently for its role or lack of role in the collapse of corporate entities in both the public and private sectors. Indeed, it is this increasing attention on internal audit that provided stimulus for this inquiry.

In addressing the terms of reference for the inquiry into internal audit, the Committee's report refers to three well documented corporate cases—two corporate failures in the Victorian public sector and one audit failure in the private sector in New South Wales. The Committee felt that a summary of these three examples would provide a useful contribution to the background to the inquiry.

Victorian Economic and Development Corporation

The Victorian Economic and Development Corporation (VEDC) was a statutory authority established in 1981 to facilitate and encourage the development of Victorian industry. It was restructured in 1984 to become the principal agency for the provision of loan and equity funds to targeted firms to stimulate economic activity. It was particularly focussed on assisting development of project proposals, such as those involving new technologies and new markets, which had difficulty raising funds through conventional means. That is, it was involved in financing relatively high risk developments.

The VEDC increased its lending each year from 1984, so that at 30 June 1988 it had loans outstanding of $260 million. It was intended to recoup some of the loans, once projects were up and running, through the issue of public shares. However, this proved untenable after the stockmarket crash of October 1987.

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[5] S8, p.1.

In November 1988, the Victorian Treasurer commissioned Fergus Ryan of Arthur Andersen to inquire into the objects, powers and functions; management and investment procedures; and assets and liabilities of the VEDC.[6]

In his report of December 1988, Ryan found that the VEDC was technically insolvent, with a deficiency of shareholders' funds of $79 million at 30 November 1988. He was critical of the VEDC Board, management and the internal auditors.

Of most relevance to the Public Accounts Committee's inquiry is Ryan's conclusions regarding the internal audit, which was conducted by Arthur Young (Chartered Accountants). Ryan interpreted the contract between the VEDC and Arthur Young to assume that the internal auditor would address each of the major business risk areas of the VEDC. Those risks should have included a heavy emphasis on the assessment, approval and monitoring of loans and investments. However, in Ryan's opinion, the internal auditor had not submitted an audit report on the adequacy and effectiveness of internal controls and procedures since 18 September 1986, and that report related to work for the financial year to 30 June 1986. This was regarded to be inadequate.

Also of relevance is the involvement of the external auditor—the Auditor General—and his relationship with the VEDC Board. Independently by letter of 13 March 1987, the Auditor-General expressed concern to the Chairman of the Board about the way in which the VEDC was monitoring its loans and investments. A review by the Auditor-General of the deficiencies in monitoring procedures was reported to the General Manager on 24 March 1988, but this was not referred to the Board until the 5 August Board meeting. Ryan felt that if the report had been promptly acted upon, it is likely that losses could have been minimised by the prompt execution of "damage control" measures.

In the context of the Committee's inquiry, this case gives a good example of how ineffective internal audit failed to give management early warning of risk exposures of the business.

Tricontinental

The Tricontinental group of companies was the merchant banking arm of the then State government owned State Bank of Victoria. In the late 1980s, Tricontinental lost $2.4 billion through high risk lending. The Victorian Government stepped in with taxpayer-funded support amounting to $727 million in 1990 and 1991, and the State Bank was eventually sold to the Commonwealth Bank.

A royal commission into the Tricontinental loss and subsequent government bailout was announced in September 1990, and the final report was released in September 1992.[7] The report says that the situation arose because the State Bank directors were unaware of the extent of Tricontinental bad debts when Tricontinental was absorbed in May 1989. The

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6 This account was mostly taken from F. Ryan, 1989: *Report of Inquiry, Victorian Economic Development Corporation*, Victorian Legislative Assembly, Melbourne.

7 A. E. Woodward & D. G. Williamson, 1992: *Final Report of the Royal Commission into the Tricontinental Group of Companies*, Government Printer, Melbourne.

ultimate cost to the State of the disaster, after the sale of assets, was estimated in the report to be $840 million.

Tricontinental was using the firm of KPMG Peat Marwick as both the internal and external auditor. A significant contributing factor to the loss was that KPMG Peat Marwick was instructed by the managing director to concentrate internal audit efforts on Tricontinental's capital markets, corporate funding and cash trusts, and not on corporate services, project financing and investment banking. That is, the scope of audit was restricted by the auditor being steered away from certain high risk parts of the business, without the knowledge of the full board of directors.

This case clearly demonstrates that to be effective, internal audit must be independent both of management and external audit.

AWA Ltd

AWA Ltd, a large public company in the electronics industry, employed a new manager to run its foreign exchange operations in 1986.[8] Simultaneously the board of directors laid down a policy of limiting the exposure of this part of the business.

In 1986 the foreign exchange operations made quite substantial profits from speculating on foreign exchange markets, but large losses overtook the profits the following year. The net lost amounted to $38 million, and the company sued its auditors—accounting firm Deloitte Haskins and Sells (now Deloitte Ross Tohmatsu) for the full $38 million plus interest for failure to report to the board of directors of the company.

In a very high profile New South Wales court case it was alleged that AWA management did not put into place adequate internal controls or establish proper books and records consistent with the board's policy on the foreign exchange operations. Deloitte Haskins and Sells carried out two external audits of the company. On neither occasion did Deloittes bring to notice the full extent of the operations of the foreign exchange division, the deficiencies in controls over foreign currency operations, or the existence of loans covering foreign exchange losses.

The auditors advised AWA management of some defects in the records and internal controls. However, for two and a half months, management did nothing about those warnings. The auditors failed to act in the meantime because they did not report to the board the inadequacies of internal control systems and the limited scope of the staff internal audit to address major risk exposures of the company. The board of directors was not informed of the true position until well into 1987.

Deloittes argued in the case that it was under no duty to report on problems relevant to internal matters. In addition it counterclaimed against the board of directors and the banks on the basis that the loans had been entered into negligently.

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8 This account was largely taken from newspaper articles and Bob Baxt, 1992: AWA and the case of the non-executive director, *Chartered*, October 1992, pp. 16–19.

In an interim judgement in November 1992, Justice Andrew Rogers ruled that the auditors should pay the major share (80%) of damages incurred by the company for failing to point out accounting problems strongly enough to the AWA board. In April 1993, Justice Rogers determined the damages to be $17 million, and ordered the auditors to pay their share of $12.2 million to AWA. Justice Rogers estimated legal costs of all parties in the series of protracted hearings to be over $20 million, and these are to be shared between the auditors and the company.

The lesson from this case that is applicable to the Committee's inquiry is that internal audit must possess or have access to skills and competencies necessary to address all of the risk exposures faced by a business.

AIM OF THIS REPORT

TERMS OF REFERENCE

On 23 September 1992, the Hon. George Souris, MP—Minister for Finance and Assistant Treasurer—requested the Public Accounts Committee under s. 57(1)(f) of the *Public Finance and Audit Act 1983* to review internal audit within the New South Wales public sector, taking particular account of:

- the statutory requirement for and recognition of internal control and audit that are appropriate to address the accountability challenges of the 1990s;
- management responsibilities for internal audit including internal audit charter, scope of audit coverage, and the mandate for internal audit to cover the main activities of an authority and subsidiary and controlled entities;
- the reporting responsibilities of the internal audit;
- the relationship between internal audit and other agencies of government;
- quality assurance on internal audit;
- appropriate management and board relations to the internal audit function, including the role and operation of audit committees;
- the competency and capacity of internal audit, including the minimum size necessary for an in-house function, the extent of competency of in-house internal audit, and appropriate arrangements for contracting the function;
- any other matters relating to the improvement of internal control within agencies of government aimed at improving accountability.

Mr Souris also requested that the Committee could review the NSW Treasury's guidelines on internal audit, and refer to the recent Commonwealth Auditor-General's report on results of a survey of internal audit in the Commonwealth public sector.

TARGET OUTCOMES

The primary outcome that the Committee would like to see from this report is a raising of the profile of internal audit in the public sector. In particular, the Committee has attempted to raise the awareness and understanding among public sector managers about their responsibilities for internal control, and the assistance that internal audit can provide to them in discharging those responsibilities. This in turn should lead to increased resources for internal audit, a corresponding increase in internal audit effectiveness, and an improvement in public sector accountability.

Several methods have been used by the Committee in this report to achieve this outcome. The method preferred by the Committee, and encouraged by a submission from three internal audit practitioners,[9] is to educate managers in the valuable role internal audit can play. This allows and encourages managers to be flexible, creative and adaptive, rather than forcing prescriptive procedures onto them. The Internal Audit Bureau actually suggested that this could be done through a NSW Treasury circular to all agencies spelling out requirements for internal audit and control.[10] The Committee hopes that this report will have the same effect, but be much more robust by invoking some major changes to the internal audit environment. To this aim the Committee intends to promote management training in internal audit as a follow-up to this report.

One of the more obvious options open to the Committee was to recommend stronger legal backing for internal audit. This has the benefit of making reforms mandatory, but the Committee has tried to avoid being too prescriptive—the Committee is only too well aware of the problems that result from hastily considered legislation. The NSW Treasury would have responsibility for initiating legislative changes, and the Committee expects that in doing so, proper consideration of options and consequences will be given. It is a current requirement for proposed amendments to the legislation on finance, accounting and reporting to be referred to the Public Accounts Committee for comment. In this way the Committee would have the opportunity for a "second bite of the cherry" to ensure that the intent of its recommendations are implemented in proposed legislation prior to consideration by Parliament.

The Committee also believes that some clear, agreed internal audit standards would be of significant assistance to both internal auditors and managers, as both would then have some benchmarks against which audit performance can be measured. Accordingly, the Committee has recommended that the NSW Treasury take the running on this issue, rather than just leave it to the professional bodies and standards associations, and give such standards some force by issuing them as a Treasurer's Direction. The NSW

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9 S13, p. 2.

10 S9, p. 20.

Treasury guidelines on internal audit also require revision and a greater focus on CEOs' responsibilities.

The Committee recognises that internal auditing is a highly specialised and professional field. The Committee has tried to avoid detail about how an internal auditor carries out his/her responsibilities. For example, the Committee received specific evidence on risk-based methodologies for internal audit,[11] but avoided detailed comment on this matter which the Committee regards as one for the profession itself. Rather, the Committee has tried to look at the framework in which internal audit in the public sector works, and particularly the relationships between internal audit, management, and the external auditor.

This report is directed to a wide readership. The main readers for which the report was written are chief executive officers and other senior line managers in government agencies, internal audit managers and staff, other (central) agency staff who are responsible for administering or reviewing or carrying out internal audit (Treasury, Auditor-General, IAB, ICAC, Ombudsman, Premier's Department), members of Parliament, and students of public sector administration.

METHOD OF INQUIRY

When it received the reference from the Minister for Finance and Assistant Treasurer, the Committee decided to launch this inquiry with a seminar on internal control and audit. The seminar also marked the 90th anniversary year of the Public Accounts Committee.

A panel of experts was brought together in the seminar to address relevant aspects of internal control and audit:

- Ian Temby, QC—Independent Commissioner Against Corruption—spoke on how incompetent internal audit is a catalyst for corruption.
- Sir Harold Knight—former Governor of the Reserve Bank of Australia—
- addressed the role of directors in delving into the operations of organisations.
- Jim Kropp—Senior Partner of Price Waterhouse—recounted AWA and other recent corporate collapses and failures and considered the lessons for internal audit.
- Tony Harris—the New South Wales Auditor-General—explained how effective internal auditors were his allies.
- Paddy McGuiness—journalist from *The Australian*—talked on the role of the media as an internal audit watchdog.

The seminar was judged to be an outstanding success on the basis of a full house of 200 participants, with seats having to be restricted, wide media coverage of the event, and a positive response from many of the participants.

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[11] S5, pp. 8-9; S6, p. 8.

The inquiry was not publicised through the newspapers, as is usual practice for Public Accounts Committee inquiries. Instead, a more focussed approach was taken by advising all chief executive officers, finance directors and internal audit managers of New South Wales government agencies, and all members of Parliament of both the seminar and the inquiry. Articles were also published in the newsletter of the New South Wales Division of the Australian Society of Certified Practising Accountants[12] and the national newsletter of The Institute of Internal Auditors—Australia.[13]

The Committee received 20 written submissions for the inquiry (appendix 1) and heard evidence from 59 witnesses over six days of hearings (appendix 2).

Two surveys were carried out. The first was a survey of 81 annual reports to determine the extent of disclosure of internal audit, particularly the position of an in-house internal audit unit in the organisational chart of an agency (appendix 3). The second survey was devoted to the size of internal audit units with regard to positions and salaries, the qualifications of internal audit staff, and support for continuing training and education. For this second survey, information was collected from 21 medium to large agencies (appendix 4).

The Chairman and staff attended a two day IIR conference on internal control and audit in the public sector,[14] at which the Chairman also presented an address on the progress of the Committee's inquiry. The conference was an excellent opportunity to learn about current issues and to discuss matters with internal auditors and other people from a wide background.

REPORT STRUCTURE

Beyond this introductory part of the report, issues relevant to internal audit have been addressed in terms of:

- factors external to an agency, such as the legal requirement for internal control and audit, role of other agencies in internal audit, and professional internal audit standards;
- factors within the agency, such as management responsibilities for internal control and audit, and relationships between management, boards and internal audit;
- factors within the internal audit unit of the agency or internal audit contractor, such as responsibilities of internal audit, and the relationship between internal audit and external audit.

In this structure, which could be thought of as three concentric zones, the report attempts to progressively increase its focus on the internal auditor at the centre. The terms of reference are fully dealt with in this "three concentric zone" approach, with a terms of reference checklist presented in the *Conclusions*.

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[12] *CPA News*, October 1992, p. 1.

[13] *NEWSAUD*, National Newsletter, The Institute of Internal Auditors—Australia, September 1992, pp. 22-23.

[14] Conference held on 3 & 4 May 1993, at The Golden Gate, Sydney.

The appendices to this report include:
- list of submissions considered for the inquiry,
- list of witnesses at hearings and page references in the Minutes of Evidence,
- results of the survey of annual reports with regard to internal audit,
- list of agencies surveyed with regard to internal audit, and the questions asked in the survey,
- list of exhibits tabled in hearings.

PART I

BEYOND THE AGENCY

CHAPTER 1: LEGAL REQUIREMENTS FOR INTERNAL CONTROL AND AUDIT

CURRENT REQUIREMENTS

Background

The *Public Finance and Audit Act 1983* (NSW) was the second statute in Australia (after a 1978 Queensland act) to recognise internal audit in the public sector.

Before 1983, the collection and payment of public money and the audit of the New South Wales public sector were regulated by the *Audit Act 1902*. The Act provided for external audit by the Auditor-General, and emphasised penalties which could be placed on individual accounting officers who were found to be at fault in financial management.

The need for the statutory recognition of internal control and the requirement for internal audit were recommended to the New South Wales Government in a report by the Audit Act Review Committee in February 1983. This Committee, composed of officials from the NSW Treasury and the Premier's Department and the then Auditor-General, reviewed the accounting, financial management and audit requirements of the New South Wales public sector.

The Audit Act Review Committee concluded that the head of each authority should be required to ensure that a sound system of internal control and internal audit was in place in each department and authority. In its report the Audit Act Review Committee recommended:

> That the Department Head be required to ensure that there is an effective system of internal control over the financial operations of the Department or Authority including -
>
> (i) the establishment and maintenance of an effective internal audit unit wherever practicable. Such internal audit to report directly to the executive level of management.
>
> (ii) the preparation and maintenance of an accounting manual which shall be in accord with the Treasurer's Directions and set forth the detailed particulars of financial systems of the organisation.[15]

The eventual introduction of the *Public Finance and Audit Bill 1983* by the then Treasurer—the Hon. Ken Booth, MP—was supported by both sides of Parliament. In the Treasurer's second reading speech, support for the provision of internal control and audit was articulated as follows:

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[15] op. cit., p. 6.

> Important features of the principal bill include an emphasis on responsibility of departmental heads to ensure proper accounting systems and expenditure controls, including the internal audit function; provision for the preparation of the public accounts in their revised format; strengthening of auditing provisions in relation to statutory authorities and departments generally.[16]

During the parliamentary debate, Michael Egan, MP—then a member of the Public Accounts Committee under the Audit Act of 1902—spoke on the recognition of internal control and the requirement of internal audit:

> That is a significant provision. It refers to internal control. Clause 11 of the bill, which deals with internal control and audit, shows that the principal bill places the responsibility on the heads of public bodies to ensure there is an effective system of internal control over financial operations and related operations of the authority. That includes management policies, sound practices for the efficient, effective and economical management of functions by each organisation or brach or section within the authority, and a system of authorisation and recording and procedure adequate to provide accounting control.[17]

The then Opposition supported the general intent of the Bill in the following words from Jack Boyd, the National Party spokesperson on Treasury matters and also a member of the Public Accounts Committee:

> The bill contains many good provisions that I support. It is a good bill. I commend the Treasurer for bringing it forward. I assure him that the National Party will continue to support it in every way.[18]

Such bipartisan support was a very important factor in the success of financial reforms in the New South Wales public sector since the early 1980s.[19]

This statutory recognition of internal audit was acknowledged by Ian Temby, QC—the Independent Commissioner Against Corruption—as placing New South Wales in the forefront of public sector financial reform. Speaking at the Committee's seminar on internal control and audit, Commissioner Temby said:

> Another positive is that New South Wales is one of the first, not just in Australia but in the world, to impose a statutory requirement for internal audit upon departments and agencies. That is but one example of this State being in the very forefront of reform . . .[20]

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16 Hansard, 10 November 1983, p. 2954.

17 Hansard, 24 November 1983, p. 3512.

18 Hansard, 24 November 1983, p. 3511.

19 Opening address by Jim Longley, MP, in Public Accounts Committee, 1992: *Report of Proceedings of the Seminar to Review Progress of Financial Reform in the New South Wales Public Sector*, Report No. 63, p. 3.

20 Public Accounts Committee, 1992: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*. Report No. 69, p. 15.

The Act

Section 11 of the *Public Finance and Act 1983* is devoted to internal control and audit as follows:

Internal control and audit

11. (1) The Head of an authority shall ensure that there is an effective system of internal control over the financial and related operations of the authority, including:

(a) management policies and requirements made by the provisions of this Act and the prescribed requirements;

(b) sound practices for the efficient, effective and economical management of functions by each organisational branch or section within the authority;

(c) a system of authorisation and recording and procedures adequate to provide accounting control in relation to assets, liabilities, receipts and expenses;

(d) proper segregation of functional responsibilities; and

(e) procedures to review the adequacies of and compliance with the system of internal control.

(2) Wherever practicable, the Head of an authority shall establish and maintain an effective internal audit organisation which shall be responsible to the Head of an authority for:

(a) the regular appraisal of the adequacy of and compliance with the system of internal control;

(b) the review of operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned; and

(c) the reporting directly at regular intervals to the Head of the authority as to the result of any appraisal, inspection, investigation, examination or review made by the internal audit organisation.

(3) The Head of an authority shall supervise the preparation and maintenance of an accounting manual for use within the authority.

(4) To the extent of any inconsistency between the provisions of the regulations or the Treasurer's directions and the provisions of an accounting manual, the provisions of the regulations or the Treasurer's directions, as the case may require, shall, to the extent of the inconsistency, prevail.

Internal control as provided by s. 11(1) are addressed in this report on page 49.

Section 11(2) actually provides the mandate for the scope of internal audit and covers (a) review of adequacy of and compliance with internal controls, (b) review of compliance with plans, and (c) reporting results of audit. The scope of audit is addressed in this report on page 82.

Accounting manuals are also an important element of internal control, and are discussed on page 55.

Treasurer's Directions

In s. 9(1) of the Public Finance and Audit Act, provision is made for the Treasurer to "from time to time, issue directions to accounting officers and officers of an authority with respect to the principles, practices and procedures to be observed in the administration of the financial affairs of the State and may, at any time, amend, vary or cancel a direction so issued."

Without limiting the generality of subsection (1), s. 9(2) gives a list of financial administration matters that may specifically be the subject of Treasurer's Directions. Although internal audit is not listed, Treasurer's Directions 720.01-720.03 refer to internal control and audit:

> The Head of an Authority shall ensure that there is an effective system of internal control over the financial and related operations of the Authority, in accordance with Section 11 (1) of the Act.
>
> Wherever practicable, the Head of an Authority shall establish and maintain an effective internal audit organisation, which shall be responsible to the Head of the Authority.
>
> NOTE: With regard to Internal audit procedures, Authorities should refer to the manual "Treasury Guidelines for Internal Audit" which is available from the Government Printing Office or the N.S.W. Government Information Service.
>
> The Head of an Authority shall supervise the preparation and maintenance of an accounting manual for use within the Authority.

The Committee considers that using Treasurer's Directions in this way to summarise s. 11 of the Public Finance and Audit Act adds nothing to the requirement for chief executive officers to establish internal controls, including an effective internal audit function. The reference to internal audit guidelines is weak and gives those guidelines no substantive backing.

Later in this report (page 41) the Committee recommends that Treasurer's Directions could be more effectively employed to incorporate standards for internal audit in the New South Wales public sector.

Treasurer's Directions 730.01-740.01 cover requirements for internal controls for computer based financial systems, and appear to give much clearer direction to finance managers than the preceding Treasurer's Directions on general internal audit. This in turn should give auditors some assistance in evaluating such internal controls.

THE NEED FOR IMPROVEMENT

In this inquiry the Committee has considered the need to continue the statutory recognition of internal control and audit. The concept of "let the managers manage" and a perceived interest by the general public for a reduced role by government in regulation and detailed prescription of procedures has, in some areas, resulted in the government withdrawing from controlling and regulating activities that can just as effectively be handled by the private sector and industry self-regulation. With this in mind, is the current legislation too prescriptive? On the other hand, is it sufficient, and does it achieve the objective of increased public accountability?

In submissions to the Public Accounts Committee for this inquiry, there was widespread support for continued statutory recognition of internal control and audit. Submissions in support of s. 11 of the Public Finance and Audit Act came from international public accounting firms, professional bodies, and heads of government agencies. The Committee did not receive any submissions advocating the deregulation of internal control and audit.

In supporting the current legislation, a submission from Deloitte Ross Tohmatsu—one of the "big six" international accounting firms—asserted that the current legislation is appropriate:

> We consider that the current NSW state legislation requiring each government entity and department to have an internal audit function to be appropriate. As you are probably aware this area has also been examined at Federal level by the Australian National Audit Office (ANAO). We note their recommendation that such a requirement should be introduced at Federal level.[21]

The submission also recommended that standards for internal audit be included in the statute.

Ernst & Young, another of the "big six", noted the current legislative requirement and considered that the statutory requirement was too narrow and should be expanded. The submission stated:

> It is Ernst & Young's submission that the above statutory requirements are too narrow to provide internal audit with the opportunity to most effectively assist management, and therefore the elected government, to meet the challenges of accountability of the 1990's.
>
> Specifically, in our opinion, internal audit should also play an important role in ensuring accountability through such areas as:
>
> (i) efficiency and effectiveness auditing; and
>
> (ii) fraud control and prevention.[22]

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[21] S11, p. 2.

[22] S5, p. 3.

Two professional bodies made written submissions to the Committee in support of the current legislative requirement. The Institute of Internal Auditors—Australia, the Australian arm of an international body based in the USA, supported the current legislation with the following recommendation to the Committee:

> The existing statutory requirement on internal control be expanded to incorporate the primary objectives of internal control, viz:
>
> - the reliability and integrity of information;
> - compliance with policies, plans, procedures, laws and regulations;
> - the safeguarding of assets;
> - the economical and efficient use of resources;
> - the accomplishment of established objectives and goals for operations and programs.[23]

In another submission, the Australian Society of Certified Practising Accountants acknowledged the current statutory requirement for internal auditing, but said that "the legislation is silent on the precise details".[24]

The Water Board's submission supported the concept of internal audit, and noted the wide range of developments, including the new legislation, that had affected the internal audit function in the New South Wales public sector since the late 1970s. The submission suggested that "An internal review function has to take account of all of these directions for change in meeting the Chief Executive Officer's needs."[25]

In its submission, the New South Wales Technical and Further Education Commission recommended to the Public Accounts Committee that one of the ways the Committee can assist agencies in achieving greater accountability is by "ensuring that there continues to be a legislative base for internal audit and review as currently outlined in the Public Finance and Audit Act."[26]

For the Commonwealth public sector the Australian National Audit Office undertook a survey of internal audit within the Commonwealth public sector and recommended the following:

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23 S6, p.3.
24 S14, p. 2.
25 S10, p. 2.
26 S8, p. 5.

The ANAO has recommended that the Department of Finance:

- propose to the Government that new financial administration legislation require all Commonwealth organisations to have an internal audit function to assist their managements and, where applicable, boards in the discharge of their obligations under the legislation[27]

The Committee has concluded from this evidence that statutory backing for both internal control and internal auditing should continue. The matter of whether the legislation requires strengthening is more complex, as numerous witnesses and submissions to the inquiry suggested changes that encompass a wide range of issues.

The Committee considered all of these suggestions, and has concluded that scope exists to substantially strengthen the legislation, and that such strengthening is highly desirable. In fact, many of the Committee's recommendations in this report propose legislative changes to raise the profile of internal audit as an important management tool for chief executive officers.

It is timely to consider such legislative change in light of a current review of the Public Finance and Audit Act and annual reporting legislation being conducted by an interdepartmental working party co-ordinated by the NSW Treasury. The Committee expects that the Government would take the opportunity of this review to implement the Committee's recommendations for legislative change in the new statute covering finance, accounting, audit and reporting in the New South Wales public sector. Rather than deal with those issues here, however, the Committee felt that it was more effective to deal with legal requirements in the context of the issues themselves as set out in the remainder of this report.

AREA HEALTH SERVICES—A SPECIAL CASE

In the course of this inquiry, the Committee undertook a special review of the accountability relationships within the health sector. The health sector in New South Wales has the biggest share of the total state budget outlays ($4.03 billion in 1992-93). The Committee was concerned to realise that area health services which administer hospitals and related budgets in the Sydney, Newcastle and Illawarra regions are not statutory authorities covered by the Public Finance and Audit Act. Instead they are incorporated under the *Area Health Services Act 1986*. Resulting from this, the internal control and audit requirements of the Public Finance and Audit Act do not apply, as the services are covered by the Accounts and Audit Determination of the Department of Health.

The Committee heard evidence from the Department of Health that Section 7, clause 7 of the Accounts and Audit Determination is based on the internal control and audit provisions of s. 11 of the Public Finance and Audit Act.[28] However, as area health

[27] The Auditor-General, 1990: *Survey of Internal Audit in the Commonwealth Public Sector*, Audit Report No. 6 for 1990-91, September 1990, p. 6.

[28] Minutes of Evidence, p. 47.

services are not statutory bodies as defined by the Public Finance and Audit Act, they are also not required to report annually to Parliament. They are, however, reporting entities in the financial sense, and their financial statements are audited by the Auditor-General under the provisions of ss. 44 and 45 of the Act relating to "particular audits". The Committee has seen annual reports for 1991-92 for all area health services, even though they were not tabled in Parliament.

The Ambulance Service is a similar case, although it is constituted separately under the *Ambulance Services Act 1990*. The Committee has been unable to obtain an annual report from the Ambulance Service for 1991-92 in the course of following up a previous inquiry into the Service.[29]

An argument could be made that the annual report of the Department of Health is largely a consolidation of reporting on activities and finances of the area health services and the Ambulance Service. However, the Ambulance Service receives only passing mention in the Department's 1991-92 report. Problems with internal control and internal audit in area health services during 1991-92 have been identified by the Auditor-General,[30] and specific internal control failure of one area health service, poorly reported in its annual report, is detailed later in this report (page 90).

The Committee concludes that the current arrangement with area health services and the Ambulance Service does not require these bodies to be fully accountable to the Parliament. Even though they are entities controlled by the Department of Health, many of them have budgets larger than some departments—$337 million for the Central Sydney Area Health Service in 1991-92—and the Committee believes that they are large enough to be subject to the same accountability requirements as statutory bodies generally.

In evidence before the Committee, the Acting Chief Accountant of the NSW Treasury advised that:

> . . . we are in the process of revising the Public Finance and Audit Act, and the intention is to bring those area health services within the Public Finance and Audit Act, and subsume them under the Department and have them listed on Schedule 3 of the Public Finance and Audit Act.[31]

This may indeed be an improvement. However, the Committee feels that much greater accountability to Parliament could be achieved if the area health services, the Ambulance Service, and proposed country-based regional health services were listed separately as statutory bodies in the replacement of Schedule 2 of the current Public Finance and Audit Act.

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[29] Public Accounts Committee, 1989: *Report on the New South Wales Ambulance Service*, Report No. 44.

[30] *New South Wales Auditor-General's Report for 1993*, Volume 1, p. 218.

[31] Minutes of Evidence, p. 216.

RECOMMENDATION 1

Financial and reporting requirements for area health services are totally inadequate. To rectify this, the Treasurer should list area health services, the Ambulance Service, and proposed country-based regional health services separately as statutory bodies in the replacement of Schedule 2 of the current Public Finance and Audit Act.

CHAPTER 2: ROLE OF OTHER AGENCIES IN INTERNAL AUDIT

Agency managers and internal auditors must be aware of the role of other government and independent agencies with responsibilities for public accountability, particularly in relation to internal audit. These agencies comprise the NSW Treasury, the Auditor-General, the Internal Audit Bureau, the Premier's Department, the Independent Commission Against Corruption, and the Ombudsman.

NSW TREASURY

The NSW Treasury is the central agency of government responsible for management of the State's finances. It comprises the Office of Financial Management and the Office of State Revenue. The latter collects the revenue that is used by the Government to finance services for the people of New South Wales. The former advises the Government generally on the growth and development of the New South Wales economy, and promotes the efficient and effective management of resources in the public sector of that economy.

Except for ss. 28, 29, 30 and 34 and schedule 1 (relating to the Auditor-General), responsibility for the *Public Finance and Audit Act 1983* lies with the Treasurer. The Accounting and Finance Division of the Office of Financial Management ensures the efficient administration of the financial provisions of the Act, including updating and improving accounting systems and practice in the New South Wales public sector. Responsibilities of this Division also include the development and monitoring of public sector accounting policies and procedures issued by the Treasurer, and compliance with the annual reporting legislation.

The NSW Treasury has recently changed the cash management procedures in the public sector. The NSW Treasury used to act as the Government's banker for all agencies, but cash is now allocated to agencies based on cash flow forecasts. This has necessitated revised internal control procedures for all agencies, as well as requiring a change in the emphasis of audit because of the inherent increased risk of the new banking system.[32]

It was rather surprising to the Committee that, given the fundamental role and responsibilities of the Office of Financial Management with regard to internal audit in the public sector, a submission was not received from the Office until late in the inquiry in response to a specific request (S18). Nevertheless, the inquiry benefited from informal discussions and formal hearings with senior staff of the Office.

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[32] S9, p. 17.

AUDITOR-GENERAL

The Auditor-General, under Part 3 of the *Public Finance and Audit Act 1983*, is the external auditor of the Treasurer's Public Accounts, and all government agencies and their subsidiaries in New South Wales. There are three traditional roles of the Auditor-General:[33]

- to audit the financial statements of individual government agencies and form opinions on whether they are presented fairly and in compliance with the requirements of the Public Finance and Audit Act, and Australian accounting concepts and standards;
- to report the result on the associated audit of the financial statements to the responsible ministers and the head of the agency;
- to report to Parliament on the results of audit of the State's public sector.

Although the work of the Auditor-General is chiefly concerned with auditing compliance with requirements of financial management, recent legislative changes (Division 2A of the Public Finance and Audit Act) have empowered the Auditor-General to review the efficiency, effectiveness and economy of *any* particular activities of an agency and compliance with all relevant laws. The Public Accounts Committee has recently concluded a separate inquiry into this aspect of the Auditor-General's work.[34]

It is usual for the external audit to involve a review of the effectiveness of an agency's internal controls, including internal audit, which impact on the financial statements. It is inevitable, therefore, that internal auditors will have contact with staff of the Auditor-General's Office. Material problems identified by the Auditor-General with internal controls in agencies are reported in the Auditor-General's reports to Parliament, and these reports are in turn reviewed by the Public Accounts Committee. In 1992, the Auditor-General reported internal control problems in many agencies. Such problems covered a wide range of financial and related operations, including delays in reconciliations, problems in payroll systems, lack of security and off-site backup for computerised information systems, disputes in calculations of employees' entitlements, lack of an up-to-date accounting manual, disputes over valuation and depreciation procedures, and incomplete asset registers. The Auditor-General therefore provides a critical link in the public sector accountability chain between an agency and the Parliament.

The Auditor-General provided a helpful submission at the outset of this inquiry (S0), provided the assistance of one of his officers for the inquiry, presented a paper to the Committee's seminar on internal audit, gave evidence in public hearings on two occasions (one of which was in company with staff of his office), and provided written information as a follow-up to the second hearing (S15).

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[33] J. R. Mitchell, 1993: *Accountability, ethics and internal control.* Page 2 in paper presented at IIR conference on *Internal audit and control—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney.

[34] Public Accounts Committee, 1993: *Review of Special Auditing Function of the Auditor-General's Office*, Report No. 70.

The Auditor-General was the subject of criticism in a submission and in oral evidence from the Internal Audit Bureau. The criticism dealt with the role of his office in providing internal audit and audit related services. Rather than deal with this issue here, the Committee decided to treat this as a decision for which management is responsible (page 73).

The relationship between the Auditor-General (as external auditor) and internal audit is a significant factor in obtaining value-for-money from the total audit of an agency. Chapter 8 is devoted to this relationship, with particular focus on the responsibility of internal audit in the relationship.

INTERNAL AUDIT BUREAU

The NSW Treasury created the Internal Audit Bureau out of its own internal audit branch in 1985 in recognition that small agencies would not be able to sustain an internal audit section of an appropriate size or calibre to provide a fully professional service. The Bureau's initial role was to provide a free internal audit function to government agencies and to supplement the internal audit function in agencies which had their own internal audit sections, but which required additional services due to workload pressure or special requirements. It still provided internal audit services to the NSW Treasury.

As part of the Government's move towards adopting commercial principles, the Bureau was taken off-budget in 1988 and was required to levy fees to cover its costs.

The *Internal Audit Bureau Act 1992* gave the bureau a statutory backing, and put it onto a fully commercial footing by freeing it from the constraints of the *Public Sector Management Act 1988*. The new Bureau is controlled by a board of management with a senior NSW Treasury officer appointed as Chairperson. However, because of the commercial nature of the Bureau's relationship with its clients, the NSW Treasury does not have access to the Bureau's reports or working papers.[35]

Agencies are not compelled to use the Bureau—it competes openly with private sector auditing firms. The Bureau currently provides internal audit services to some 50 government departments and statutory authorities.

The Committee received a substantial submission from the Bureau (S9), and heard evidence from three of its executives and the Chairman of the Board. The submission made several suggestions regarding internal audit, including internal audit and audit related services being provided by the Auditor-General.

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[35] S9, p. 7.

PREMIER'S DEPARTMENT

Within the Premier's Department, the Office of Public Management is responsible for several functions that are associated with internal audit:

- "Management review": the review of efficiency and effectiveness of government agencies
- Provision of advice to agencies on strategic planning, performance monitoring, program evaluation and organisational design
- Overseeing reform of government trading enterprises, including reviews for corporatisation and privatisation
- Assessment of capital works plans and provision of advice on asset management
- Provision of policy advice on information technology in the public service, including the issue of Statements of Best Practice.

At the IIR conference on internal audit and control, Frank Harvey spoke on a distinction made in the Commonwealth Department of Defence between internal audit and program evaluation.[36] Even the Committee's Report No. 15 distinguished between program evaluation and internal audit, but the NSW Treasury guidelines on internal audit, on the other hand, acknowledges an overlap between them.[37] From its understanding of the definition of internal audit as simply a review service to management, the Committee has concluded that any such distinction is purely arbitrary. The Committee now regards program evaluation as a form of internal audit, mostly appropriate to non-commercial agencies, where not only are programs evaluated against their objectives, but the very existence and need for the programs are evaluated against the objectives of government policy.

In chapter 5 of this report, the Committee asserts that internal audit as a review service should have the broadest practical scope. In large, complex agencies, internal audit could cover a broad range of functions, including co-operating in external management reviews, monitoring performance against strategic plans, undertaking fundamental evaluation of programs, co-operating with external reviews for corporatisation and privatisation, monitoring development of capital works plans, working towards protection of assets, and monitoring developments in and maintenance of information technology.

The Office of Public Management is available to all agencies for advice or assistance in the examination of operations, analysis of performance, and implementation of reforms.

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36 F. Harvey, 1993: *Case study: the role of internal audit and control in management strategies—Department of Defence*. Page 4 in IIR conference on *Internal control and audit—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney.

37 op. cit., p. 5.

INDEPENDENT COMMISSION AGAINST CORRUPTION

The Independent Commission Against Corruption (ICAC) was established in March 1989 under the *Independent Commission Against Corruption Act 1988*. Under s. 11 of this Act, the chief executive officer of every government agency has a responsibility to report to the ICAC any matter that the officer suspects may be corrupt conduct. Corrupt conduct has an extremely wide definition in the Act, and includes fraud, extortion, bribery, theft, blackmail, perverting the course of justice, embezzlement, tax evasion, illegal gambling, forgery, and many other breaches of public trust.

The ICAC has three main objectives :
- to investigate reports of suspected corruption;
- to review laws and practices and advise on changes to prevent corruption;
- to provide an education service on strategies to prevent corruption.

Since its inception, the ICAC has tabled five reports in Parliament that have dealt with problems of internal audit.

The first report was tabled in December 1990 and dealt with corruption in driver licensing at motor registries over a period of ten years.[38] The ICAC found that the quality of internal audit in the former Department of Motor Transport was poor, and in its report, enunciated some important principles of internal audit:[39]
- independence is indispensable;
- you only get what you pay for in internal audit;
- auditors must help, not hinder; and
- internal audit is not enough—it is a complementary resource and not a substitute for good management practices.

Ian Temby, QC—Independent Commissioner Against Corruption—reiterated these principles in his talk at the Committee's seminar on internal control and audit.[40]

In July 1991, the ICAC reported on contracting of helicopter services for the Maritime Services Board.[41] The contract tendering process was flawed, resulting services were unsatisfactory, and the owner of the successful tenderer was an MSB employer associated with the tendering process. Internal audit reports on a blatant problem area were found to be "gravely deficient", and the performance of the auditor in charge was regarded to be incompetent.

[38] Independent Commission Against Corruption, 1990: *Report on Investigation into Driver Licensing*, Volume 1.

[39] op. cit., pp. 214–215.

[40] I. Temby, 1993: *Incompetent internal audit—a catalyst for corruption*. In Public Accounts Committee, 1993: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, pp. 16–17.

[41] Independent Commission Against Corruption, 1991: *Report on Investigation into the Maritime Services Board and Helicopter Services.*

A report on cash handling in public hospitals was tabled in July 1992.[42] A exhaustive examination of cash handling in the Royal North Shore Hospital found that almost $4 million in cash was handled in 1991 in a wide range of outlets. Although the matter was alerted to the ICAC after discovery by internal audit of petty theft, the ICAC found that corrective action recommended by internal audit had not been implemented by management, and that internal audit itself had not followed up on action taken in response to its own recommendations.

The ICAC questioned the absence of internal audit in the granting of a major freight contract by the TrackFast Division of the State Rail Authority. In the report of September 1992,[43] the successful tenderer was shown by the ICAC to have dubious qualifications and ability to carry out the contract, as its chief activity up to that time was lawnmowing. It was covertly assisted in drafting expressions of interest for two contracts by a SRA employee responsible for assessing those expressions of interest. In this case, the General Manager of Trackfast failed to set in place suitable procedures or internal controls to ensure the integrity and security of the expressions of interest process.

The Northern Region of the State Rail Authority was the subject of the ICAC's latest report in March 1993.[44] The hire of plant and equipment in the Region was found to have involved more than a million dollars of false records during 1989 to 1991. The ICAC found that there were no effective controls to prevent this fraud, and internal audit had not been involved in the verification of payment of contractors for over two years.

These examples clearly show the importance of internal audit in preventing and detecting corrupt conduct. By this the Committee includes identifying corruption that has taken place, is in progress, or is likely to take place, and reporting such past, present or possible corrupt conduct to the chief executive officer. The IIA-A advised the Committee that the IIA has set standards and guidance for internal auditors regarding their responsibility for deterring, detecting, investigating and reporting fraud or corruption. The Committee found out that some large agencies have specialised corruption-prevention branches within their internal audit units.

Internal audit should take advantage of the knowledge and experience of the ICAC and seek its advice on corruption and possible corrupt conduct. When corrupt conduct is detected by internal audit and reported to the chief executive officer, internal audit must ensure that it is in turn reported to the ICAC by the CEO. Once the ICAC becomes involved, the internal audit should work in co-operation with the ICAC on corruption investigations and corruption prevention, particularly the training of management in ways of minimising opportunities for corruption and reviewing the adequacy of fraud control strategies. A further role of internal audit is to ensure management implementation of ICAC recommendations.

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42 Independent Commission Against Corruption, 1992: *Corruption Prevention Project—Department of Health—Cash Handling in Public Hospitals.*

43 Independent Commission Against Corruption, 1992: *Report on Investigation into the State Rail Authority—Trackfast Division.*

44 Independent Commission Against Corruption, 1993: *Report on Investigation into the State Rail Authority—Northern Region.*

OMBUDSMAN

The *Ombudsman Act 1974* gives the Ombudsman powers to investigate complaints made by the public relating to police, other State government agencies, and local government. Internal audit should keep in mind that many complaints arise from problems in systems within agencies, which in tun are reflected in reduced efficiency and effectiveness. The Ombudsman places priority on improving such systems rather than answering each individual complaint, as this is the most cost effective approach to complaint handling.[45] During management auditing, an internal auditor should therefore identify areas in which complaints are prevalent, and draw upon the experience of the Ombudsman if necessary in recommending corrective action.

Problems with reporting complaints against police recently brought to light by the media have resulted in action taken against two assistant commissioners. This is a proper area for internal audit to be involved in, yet the Committee noted in the Police Service's submission that this is given low priority in the audit plan relative to auditing of financial matters.[46] In this government agency, the manager of internal audit reports to the Assistant Commissioner (Professional Responsibility), which is the position of one of the assistant commissioners involved in failures with reporting complaints. This not only contravenes the legislative requirement for internal audit to report directly to the chief executive officer—in this case the Commissioner of Police—but it clearly compromises the internal audit's independence. The Committee expects that reporting of complaints against Police would now be given a much higher internal audit priority in the view of the recent media attention given to problems in this area. The Committee addresses this issue in greater detail in the section on reporting relationships (page 116).

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45 D. Landa, 1992: *Accountability, customer service and satisfaction in the public arena*, p. 2. Paper presented at a conference organised by the Institute of Public Administration Australia and Management Advisory Board on *Accountability—implications for Commonwealth and State administrations*, 3 April 1992, State Office Block, Sydney.

46 S12A, appendix 2.

CHAPTER 3: STANDARDS FOR INTERNAL AUDIT

WHAT DO WE HAVE TO CHOOSE FROM?

The accounting and auditing professions have received some severe criticism over the role of auditors and accountants in the corporate crashes of the 1980s. In many cases management failure has been equated to audit failure. An "audit expectation gap" has been said to exist between what an auditor hopes to achieve by adhering to professional standards and practices and what the general public expects an auditor to achieve.[47]

In a study of current issues in auditing for both the public and private sectors, James Guthrie from the University of New South Wales wrote:

> Pressures associated with audit failures have resulted in calls for drastic changes to current auditing arrangements and practices. These include . . . improvement in audit standards and practice statements and a closing of the "expectation gap" to improve audit quality.[48]

The external audit function undertaken by the Auditor-General under s. 34 of the Public Finance and Audit Act must be done "in such a manner as the Auditor-General thinks fit having regard to the character and effectiveness of the relevant internal control and *recognised professional standards and practice*" [emphasis added].

The Committee was surprised to note, however, that the Act was silent on the matter of standards for *internal audit*. Many submissions and witnesses referred to the need for clear direction, preferably through the legislation, on which standards should be applied to internal audit in the New South Wales public sector.[49]

The NSW Treasury guidelines for internal audit refer to *Standards for the Professional Practice of Internal Auditing* issued by The Institute of Internal Auditors Inc.—a professional body based in the United States. These Standards are meant to be criteria against which internal auditing is evaluated. The main points of the Standards are summarised in the guidelines "to show the essential elements of what should be in place to provide an efficient internal audit service."

Although these Standards could simply be given legislative backing, as recommended by Deloitte Ross Tohmatsu,[50] it is relevant that the two professional accounting bodies in Australia also jointly produce auditing standards, statements of auditing practice, and professional guidance to members who are auditors.

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47 *New South Wales Auditor-General's Report for 1988*, Volume 2, p. 109.

48 J. Guthrie: *Critical issues in public sector auditing*. Paper presented at Australian Society of CPAs seminar on *Public sector accountability—challenges for auditing in the 90s*, Sydney, 18 June 1991, p. 5.

49 S5, p. 9; S8, p. 5; S11, p. 2; S14, p. 3; Minutes of Evidence, p. 11 & p. 212.

50 S11, p. 2.

To further complicate the matter, in 1992 the Standards Association of Australia issued a joint Australian, New Zealand and international standard called *Guidelines for Auditing Quality Systems*.

The Committee can sense that (a) this proliferation of standards relating to auditing, (b) the absence of any mention of other standards in the NSW Treasury guidelines, and (c) a complete silence on standards in the legislation, together provide confusing direction to those involved in internal auditing, namely the auditors, agency managers, and board members.

The Committee sought to determine how this situation arose, and what should be done to provide clearer direction on the use of standards for public sector internal auditing in this State.

DEVELOPMENT OF AUDIT STANDARDS

Role of accounting bodies

In Australia, the development of the accounting profession has been underway since as far back as 1886 when the first professional body was formed in Victoria. Through a series of mergers and amalgamations, various State and local bodies were reduced to two by 1952. In 1955, the then Australian Society of Accountants appointed a full time research officer. The Society's handbook states the aim of this activity was:

> to narrow areas of difference and inconsistency in accounting practice and to further the development and recognition of generally accepted accounting standards and statements of accounting practice in pamphlet form.[51]

The two current accounting professional bodies in Australia are the Australian Society of Certified Practising Accountants (ASCPA) and The Institute of Chartered Accountants in Australia (ICA). These bodies jointly fund the Australian Accounting Research Foundation (AARF), which undertakes research on a range of technical matters on behalf of the joint membership. This research has led to a number of publications being issued to provide guidance to members on financial accounting, reporting and auditing.

Responsibility for the work of the AARF is allocated to various boards. There are two accounting boards—the Australian Accounting Standards Board traces its origin back to 1978 and oversees work on general accounting standards and concepts for Australia, and the Public Sector Accounting Standards Board was established in 1983 to focus on accounting standards and concepts relevant to all three tiers of government. The Auditing Standards Board was formed in 1981 to oversee work on auditing standards of no particular persuasion.

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[51] Australian Society of CPAs: History of the Society, ASA 2, *Members' Handbook*, Volume Four, p. 11024.

The primary documents which the Foundation prepares and issues are Statements of Accounting Concepts, Australian Accounting Standards, Statements of Auditing Standards, and Statements of Auditing Practice. The Foundation also releases exposure drafts of proposed statements to generate discussion on key areas of accounting or auditing prior to the development of standards.

To date there is one auditing standard—AUS1: *Statement of Auditing Standards*—supported by over thirty "statements of auditing practice"—the "AUP" series.

Internal audit as a separate profession

Internal auditing has only been recognised as an occupation separate from accounting since 1941 when a professional association was formed in New York—The Institute of Internal Auditors Inc. (IIA).

However, the profession or calling of internal auditing can trace its roots back to antiquity as there is evidence that very early civilisations in Mesopotamia, Egypt and Persia had in place systems of checks and balances oversighted by official witnesses. It has been reported [52] that the ancient Greeks forced slaves to be record keepers as slaves could be tortured to reveal the truth about their records. Auditors have, thankfully, improved their auditing techniques to more socially acceptable means.

In Australia, the development of internal auditing, particularly in the public sector, can be traced back to the early days of the development of the colonial administration when "examiners of accounts" or similarly titled officials undertook checks on accounting and related records as part of the accounting systems and separate from the external auditing function.

In 1948, the examiner of accounts for the then Sydney County Council arranged a meeting of known heads of internal audit units in Sydney to consider the formation of a local chapter of the American-based Institute of Internal Auditors. The chapter was formally accredited by the American head office in 1952. By 1986, chapters were operating in all Australian capital cities and in that year a national body was formed under the name "The Institute of Internal Auditors-Australia" (IIA-A). The Australian body remained closely affiliated with the American-based body.

The IIA was relatively late in developing and publishing standards for internal auditing, separate from standards developed by the accounting profession aimed primarily for external auditors.

In 1978 the IIA issued *Standards for the Professional Practice of Internal Auditing*. The standards were re-issued in 1989. The standards are accompanied by explanatory booklets and other guidance.

[52] For a more detailed history of the internal auditing profession see L. B. Sawyer, 1981: *The Practice of Modern Internal Auditing*, The Institute of Internal Auditors Inc., Altamonte Springs, Florida, USA, 1981.

In Australia, these American standards have widespread acceptance, but do not have statutory recognition. Mr Byron of the IIA-A, New South Wales Branch, told the Committee that:

> . . . they are now generally accepted word-wide standards, and we accept them in Australia.[53]

This view was supported by Mr Worthy of the Australian National Audit Office who said:

> Our view is that The Institute of Internal Auditors' standards are the most appropriate basis on which to develop public sector internal audit standards because they address particularly the requirements of internal audit. However, in saying that we believe internal auditors should pay attention to the relevant auditing standards issued by the accounting bodies. In fact, to our knowledge there is no practical difference between the two. The two standards mesh together quite well. It is The Institute of Internal Auditors' standards which are more specific to an internal audit operation. The accounting standards tend to be focussed or addressed more towards the needs of an external audit environment.[54]

Internal audit standards in the Commonwealth public sector

The Committee reviewed the development of auditing standards in the Commonwealth public service, where internal auditing has been carried out since at least as far back as 1945. The development of internal auditing in the Commonwealth was promoted by the Joint Parliamentary Committee of Public Accounts and the former Public Service Board, firstly in the late 1960s and again in the 1970s and early 1980s, after adverse references by the Commonwealth Auditor-General to the quality of internal audit.[55]

The Auditor-General reported that a review of internal audit in the Australian Public Service conducted by Coopers & Lybrand in 1976-77 concluded "there were no Service-wide internal auditing standards".[56]

In 1979 the Public Service Board proposed that departments and authorities adopt "proposed interim internal auditing standards".[57]

In 1986 Coopers & Lybrand was commissioned to again review internal audit in relation to the 1977 review. Later that year the Commonwealth Government decided that the Public Service Board would have no future role and would discontinue its role in the training and surveying of internal audit in the Australian public service.

Early this year (1993) definitive internal audit standards—*Standards for the Professional Practice of Internal Auditing in the Commonwealth Public Sector*—were issued by the

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53 Minutes of Evidence, p. 12.

54 Minutes of Evidence, p. 212.

55 The Auditor-General, 1990: *Survey of Internal Audit in the Commonwealth Public Sector*, Audit Report No. 6 for 1990-91, p. 11.

56 ibid., p. 11.

57 ibid., p. 12.

Department of Finance. These standards are largely based on The Institute of Internal Auditors' standards with some modifications to reflect both the Australian and the public service environment.[58]

About the same time, the Australian National Audit Office issued guidelines for internal auditing in the Commonwealth public sector. The guidelines are directed to both senior management and internal auditors and were developed to assist all public sector organisations to "assess and improve their internal audit operations".[59]

The guidelines addressed the issue of compliance with professional standards by public sector internal auditors and recommended:

> All Internal Audit work should be carried out in a professional manner.
>
> The Department of Finance proposes to issue standards for Internal Audit practice in the Commonwealth public sector. Managers and internal auditors should be cognisant also of the Institute of Internal Auditors "Standards for the Professional Practice of Internal Auditing" and the relevant parts of the Australian Accounting Research Foundation's "Statement of Auditing Standards and Statements of Auditing Practice".[60]

THE CHOICE OF STANDARDS FOR NEW SOUTH WALES

In May 1984, the NSW Treasury issued guidelines for internal audit in the New South Wales public sector. These guidelines were updated and re-issued in 1990 as *Internal Audit: Guidelines for Government Organisations.*

As shown on p. 20 of this report, these guidelines are referred to in the Treasurer's Direction 720.02. The wording of this Direction does *not*, in the Committee's opinion, direct a chief executive officer to comply with the guidelines.

Although the Committee acknowledges that the guidelines are useful to internal auditors and agency managers, the Committee concludes that internal audit is important enough to require a much stronger government direction than merely a note in the Treasurer's Directions that authorities should "refer" to the guidelines. The Committee feels that internal auditors and agency managers would benefit from having clearly defined *standards* of internal auditing, as advocated in the TAFE Commission submission,[61] and the government would benefit from mandatory compliance of its agencies with those standards.

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58 Minutes of Evidence, p. 213.

59 Foreword by J. C. Taylor, Auditor-General, in *A Practical Guide to Public Sector Internal Auditing.* Australian National Audit Office, Canberra, 1993.

60 ibid., p. 2.

61 S8, p. 3.

The issue of internal audit standards is fundamental to the rest of this report, because many of the other issues relevant to internal audit can be addressed through having appropriate standards.

Ideally, there should be a national set of standards for public sector internal auditing which can be used by all State and Commonwealth jurisdictions. Such standards should be developed by taking the best standards from all of those available from the accounting professional bodies, the auditing professional bodies, and the Australian Standards Association. Realistically, however, the Committee cannot see this happening in the near future, although that should not mean that the New South Wales Government should not pursue this goal.

In the mean time, it appears that the IIA's standards provide the best basis for internal auditing standards that could be applied to the New South Wales public sector. It is fortunate that the Commonwealth Government has only recently (during the course of this inquiry) released internal audit standards, slightly modified from the IIA's standards for its own use. A perusal of these standards by the Committee reveals that these could probably be adopted by this State with few modifications, for example, reference to the working relationship between internal audit and other organisations as set out above in chapter 2. Such standards could serve as an interim measure until an agreed national set of internal audit standards was developed.

At the end of this section the Committee recommends that the NSW Treasury adapt the Commonwealth's public sector internal audit standards for application to New South Wales. This would be a sound start to development of internal audit standards for our State public sector. In subsequent chapters of this report, the Committee recommends specific points that it believes should be covered by the standards, regardless of whether they are already addressed by the Commonwealth. While the Committee is happy to leave the general issue of internal audit standards to the professional discretion of officials of the NSW Treasury, these are particularly important points that the Committee believes should be incorporated in the standards.

To provide encouragement and support for the development of internal audit standards for the New South Wales public sector, the Committee recommends the establishment of an advisory group comprising representatives of the professional accounting and auditing bodies, the Standards Association, the Auditor-General, and some large government agencies. The advisory group's role should be to assist the NSW Treasury in the development of internal audit standards, as well as their ongoing review.

In the Committee's opinion, internal audit standards will achieve their objective of improving the quality of internal audit only if there is a strong requirement for them to be complied with. The strongest way would be for the standards to be incorporated in legislation, either as part of an act or a regulation. However, this would be rather inflexible, as standards do need to be able to change in response to changing accountability requirements, and legislation is difficult to change. A more flexible approach would be to incorporate internal audit standards in the Treasurer's Directions, which can be changed administratively. Although the Public Finance and Audit Act provides general legal backing for Treasurer's Directions, the Committee believes that the

Act should make specific reference to mandatory compliance with the new Treasurer's Direction on internal audit standards to give a clearer signal on compliance.

Finally, there needs to be a mechanism for *evaluating* the level of compliance of government agencies with internal audit standards. As the Treasurer is the minister responsible for the Public Finance and Audit Act, the NSW Treasury should evaluate compliance with the internal audit standards and report on that evaluation. In effect, this could largely be carried out by the Auditor-General during the annual external audit relating to the financial statements. However, as internal audit will in most cases have a broader scope than the external audit, there will need to be additional work done to evaluate full compliance with standards over the entire scope of internal audit. In view of the increasing involvement of the Auditor-General in comprehensive auditing, it would be logical to somewhat expand the scope of the annual external audit. In evidence to the Committee, the Acting Assistant Secretary of the NSW Treasury said that this was already being considered by her agency.[62] Meanwhile, the NSW Treasury favours monitoring compliance on an exception basis and on any major issues raised by the Auditor-General.[63]

The Committee is hesitant to recommend too specific an approach to reviewing compliance with internal auditing standards at this stage. Instead, the Committee feels that the most appropriate method would reveal itself once standards are in place, as well as implementation of other recommendations in this report.

RECOMMENDATION 2

The NSW Treasury and the Auditor-General should work towards the development of national standards for public sector internal auditing by the appropriate professional bodies (The Institute of Internal Auditors-Australia, Australian Society of CPAs, Institute of Chartered Accountants Australia, and Standards Association of Australia). The standards should be general enough to cover all aspects of internal auditing, not merely auditing of financial compliance.

RECOMMENDATION 3

As an interim measure, the NSW Treasury should adapt the internal audit standards developed by the Commonwealth Government, based on those of The Institute of Internal Auditors, for application to New South Wales, ensuring consistency with this State's statutory requirements. The standards should be issued as Treasurer's Directions.

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62 Minutes of Evidence, pp. 218 & 220.

63 ibid., p. 219.

RECOMMENDATION 4

In adapting the Commonwealth internal audit standards for application to New South Wales, reference should be made to the working relationship of internal audit with the Auditor-General, the Premier's Department, the Independent Commission Against Corruption, and the Ombudsman.

RECOMMENDATION 5

Standards will achieve their objective of raising the quality of internal audit only if there is a strong requirement for compliance. The Treasurer should therefore make specific *statutory* provision for New South Wales government agencies to comply with these standards.

RECOMMENDATION 6

The Office of Financial Management of the NSW Treasury should include in its annual report a section on what it has done to ensure compliance with the internal audit standards, and an evaluation of that compliance.

ARE UNIVERSITIES A SPECIAL CASE?

The Committee was surprised to note that s. 9(4) of the Public Finance and Audit Act specifically excludes Treasurer's Directions from applying to a university. This is inconsistent with other sections of the Act, for example s. 11 relating to internal control and audit which applies to all New South Wales government agencies, including universities. It would also nullify the intent of Recommendation 3 to develop internal audit standards as Treasurer's Directions, at least for universities.

This anomaly probably arose from the arrangement in which universities are essentially funded by the Commonwealth ($1.2 billion in 1992[64]), but incorporated under State law and administered by the States. Nonetheless, universities are subject to external audit by the Auditor-General, who has identified numerous problems with their financial administration, including:

- tardiness of some universities in adopting accrual accounting
- accountability of foundations
- methods of appointment of consultants
- accountability for subsidiaries.

[64] *New South Wales Auditor-General's Report for 1993*, Volume 1, p. 65.

Some of the most serious matters identified by the Auditor-General in 1992 were:[65]

- Issues, including inadequate internal audit, raised in management letters to Macquarie University appeared to have not been addressed.[66]

- Qualified audit opinions issued to CMBF Ltd, a subsidiary of Macquarie University, due to inadequacies in the financial statements and failure to maintain a separate banking account.

- Inability of the Auditor-General to express an audit opinion on the financial statements of Kensington Colleges, a subsidiary of the University of New South Wales, due to failure to maintain proper accounting records.

- No accounting records kept by SCMF Pty Ltd, the trustee of the Sydney Conservatorium of Music, which is now a subsidiary of the University of Sydney.

- Inconsistency in accounting methods between members of the University of Western Sydney, and inadequate internal audit at the Nepean campus.

- Questionable formula for determining provision for long service leave by the University of Wollongong.

Accountability of university subsidiaries appears to be a perennial concern of the Auditor-General. In 1989, the Auditor-General reported on a special review of university subsidiary companies.[67] At the time he had identified 23 companies established by the five New South Wales' universities. This included one subsidiary company domiciled in the United States and therefore not responsible directly under Australian Corporations Law and the New South Wales Public Finance and Audit Act.

The review disclosed that most of the university subsidiaries had powers "wider than the parent university itself". The Auditor-General held the view that the powers of a subsidiary company should be "limited to the powers necessary to achieve the objects with which the parent body has been charged." The Committee agrees with this concept and believes that subsidiary and controlled companies or other entities associated with any government agency should be subject to the highest level of control and direction.

The Committee considers that in line with the increasing accountability expectations of the 1990s, the Treasurer, as the minister responsible for the management of the State's finances, should have the authority to issue directions on the administration of the financial affairs of all government agencies that are accountable to Parliament, including universities and their subsidiaries. The Treasurer's Directions themselves are flexible in that they can be made to apply to all or a selection of government agencies. As far as

[65] *New South Wales Auditor-General's Report for 1992*, Volume 1, pp. 9-65.

[66] In Volume 1 of his 1993 Report, the Auditor-General referred to an inadequate level of internal audit coverage again in 1992, although an internal auditor has since been appointed and a new accounting manual has been introduced (p. 75).

[67] *New South Wales Auditor-General's Report for 1989*, Volume 1, pp. 31-39.

internal audit is concerned, there have been sufficient adverse comments about universities in Auditor-General's reports over recent years to convince the Committee that internal audit in university administration needs strengthening.

The Committee is aware of a possible move to place universities entirely under Commonwealth jurisdiction. While not wishing to express any opinion on such a move, the Committee sees that this would overcome some problems with the dual accountabilities of universities. On the other hand, if the Commonwealth does *not* take over universities, then New South Wales should, in its own interests, remove the exemption of them from Treasurer's Directions.

RECOMMENDATION 7

Universities should not be exempt from New South Wales Treasurer's Directions while they are administered by this State. If full Commonwealth control over universities is not effected by the time the Public Finance and Audit Act is replaced, the Treasurer should remove the statutory general restriction on the Treasurer issuing a Treasurer's Direction to a university.

ROLE OF INTERNAL AUDIT GUIDELINES

With implementation of the above recommendations regarding internal audit standards, the content and role of the NSW Treasury's internal audit guidelines will have to be revised.

With effective legal backing of internal audit standards, the Committee would regard the guidelines chiefly as a means of assisting auditors and agency management in understanding the standards and other legal requirements for internal audit by offering explanations and useful suggestions for their implementation. There would be no need to refer to them in Treasurer's Directions or the legislation. Instead, emphasis should be placed on keeping them up-to-date, thorough, and readily available to agencies.

Later in this report, the Committee makes specific recommendations on aspects of the guidelines. These are mainly directed to obligations of a chief executive officer. Although these obligations will not be mandatory by being included in the guidelines, the Committee would expect them to be adhered to unless they are inappropriate to a specific agency, or unless a chief executive officer can make a strong case for alternative action. In this way the guidelines can also assist CEOs in establishing sound systems of internal control. To encourage chief executive officers to adhere to at least the guidelines relevant to the financial operations of agencies, the Committee feels that the Auditor-General could monitor the adequacy of the internal audit guidelines and standards and the actual performance of internal audit in the public sector on an ongoing basis as part of the external audit.

RECOMMENDATION 8

The NSW Treasury has a substantial task to improve the framework for internal audit in this State's public sector. To assist in this task, particularly in the development and ongoing review of internal audit standards and guidelines, the NSW Treasury should establish an advisory group comprising representatives of the professional accounting and auditing bodies, the Standards Association, the Auditor-General, and some large government agencies.

RECOMMENDATION 9

With clear internal audit standards available, the content and role of the NSW Treasury's internal audit guidelines will need revision. The NSW Treasury should issue a new booklet on guidelines for internal control and audit, focussing on a chief executive officer's responsibilities in this area. The booklet should be maintained in an up-to-date and thorough way with regard to all internal audit requirements, and should be made readily available to agencies in both paper and electronic format.

RECOMMENDATION 10

Following the statutory external audit of agencies, the Auditor-General should report to Parliament on the adequacy or otherwise of NSW Treasury standards and guidelines for internal audit, and the actual performance of internal audit in the New South Wales public sector.

PART II

WITHIN THE AGENCY

CHAPTER 4: MANAGEMENT RESPONSIBILITIES FOR INTERNAL CONTROL

A chief executive officer of a New South Wales government agency has ultimate responsibility in his agency for using public resources to produce goods and/or services effectively and efficiently, and appropriate to desired outcomes in accordance with government policy. Such responsibility is usually enunciated in performance agreements with a minister, and the chief executive officer's rewards (and sanctions) are based on that performance.

As shown in page 19, s. 11(1) of the Public Finance and Audit Act also provides a fundamental responsibility on a chief executive officer of a government agency to ensure that there is an effective system of internal control over the financial and related operations of the agency. The Act specifies that these internal controls should include:

- management policies
- requirements of the Public Finance and Audit Act and associated Regulations
- sound practices for the efficient, effective and economical management of functions by each part of the agency
- a system of authorisation and recording and procedures to control accounting for assets, liabilities, revenues and expenses
- proper segregation of functional responsibilities
- procedures to review the adequacies of and compliance with the system of internal control (that is, internal audit).

To illustrate internal controls, the processing of traffic fines through the court system involves controls that have both financial and non-financial attributes. The processing of a notification of a driving offence and the resulting fine would be controlled by systems that, in broad terms, identify the infringement notice, identify the dollar value of the fine due, control cash received, identify notices satisfied by cash paid, and follow-up action on fines outstanding.

Traffic offences involving suspension of a driver's licence would involve non-financial controls designed to ensure that all infringement notices issued are accounted for, all notification of cancelled or suspended licences are transferred from the Department of Courts Administration to the Roads and Traffic Authority, and the RTA correctly records all cancelled and suspended licences.

The objectives of internal control have been addressed by the accounting profession in the following terms:

Objectives of Internal Control

Internal controls relating to the accounting system are concerned with achieving the following objectives:

(a) transactions are executed in accordance with management's general or specific authorization;

(b) all transactions are promptly recorded in the correct amount, in the appropriate accounts and in the accounting period in which executed so as to permit preparation of financial information within a framework of recognized accounting policies and to maintain accountability for assets;

(c) access to assets is permitted only in accordance with management's authorization; and

(d) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with regard to any differences.

Specific internal control procedures designed to achieve such objectives could include checking the arithmetical accuracy of the records; the maintenance of reconciliations, edit routines, control accounts and trial balances; approval and control of documents; comparison with external sources of information; comparing the results of cash, security and inventory counts with accounting records; limiting direct physical access to assets and records; and comparison of results with budget.[68]

Internal audit therefore itself is one of the forms of internal controls available to the management of an organisation. It is arguably the chief executive officer's most valuable tool to assist him in controlling the organisation, particularly in reducing the risk of things going awry, as it involves the review of all of the other forms of internal control.

The Public Finance and Audit Act (s. 11(2)) makes internal audit a direct responsibility of the chief executive officer, and this officer must establish and maintain an effective internal audit function *wherever practicable*. The words *wherever practicable* received criticism from several submissions and witnesses, as they really do not in any way assist a chief executive officer in deciding on the level and most appropriate method of internal audit. This issue is covered in some detail from page 69.

[68] Australian Accounting Research Foundation: *Study and Evaluation of the Accounting System and Related Internal Controls in Connection with an Audit*, Statement of Auditing Practice AUP12, Australian Society of CPAs Members' Handbook, Volume Two—Auditing, pp. 3089-90.

FRAUD AND CORRUPTION CONTROL

The 1990s have seen great emphasis being placed on the propriety and probity of public sector officials as they undertake their normal duties. For the NSW public sector, specific legislation on corrupt conduct has been in place for some years, and reports by the ICAC Commissioner receive wide coverage in the media.

It is clear to the Committee that in addressing the wide range of internal control issues within an organisation, the chief executive officer and line management have a responsibility to put in place systems to combat fraud and corruption.

Historically the audit function has been concerned with fraud control and detection and investigating the incidence of fraud. The modern internal auditor, however, faces a wider range of challenges in addressing the accountability requirements of the 1990s. Fraud control and detection are still important, but are not now the prime purpose of an audit.

In the 1990s, management in the private sector is seen as having prime responsibility for running the business and for putting in place systems and procedures to ensure that sound internal control, including fraud control and detection, is maintained. The external auditors' role is to examine the books and records of the company to ensure the financial results of the company are correctly stated and prepared in compliance with relevant laws. The detection and reporting on fraud are seen as a secondary role. In the recent AWA case the judge had the following to say on the roles of boards of directors, management and auditors:

> It is not for the auditors to be concerned with whether management's decisions are wise, or businesslike, or whether the business should be conducted in a different way. It is for management to establish information and control structures. It is for management to keep the books of accounts and to prepare the accounts for shareholders and for regulatory bodies in appropriate cases. The auditor's function is to ensure that the financial results of the company are correctly stated in the accounts laid before the shareholders. As part of that duty, and by law, the auditors are required to consider whether proper books of account have been kept by the company. The division of function broadly stated is the company, Board and management are concerned with all that pertains to the affairs of the company. The auditors' concerns are confined to the financial aspects and that only in a secondary and reporting capacity.[69]

In response to calls for a tightening up on the standards and professional practices applying to auditors, the Auditing Standards Board of the AARF has issued two new auditing practice statements updating the auditors' responsibilities in detecting and reporting fraud and other illegal acts.

Since 1983, auditors have been given specific guidance on their responsibilities to detect and report on fraud and error through Statement of Auditing Practice AUP16. A major revision of this statement was undertaken as a result of the AWA case and other cases. It

[69] Rogers, J., 1992: p. 1652 in AWA Ltd v. Daniels trading as Deloitte Haskins & Sells & others (No. 2) (1992) *10 Australian Company Law Cases 1643.*

was felt that the 1983 version of AUP16 was inadequate to deal with the wider scope of regulations which could have an impact on the financial reporting of private and public sector entities.

The revised Statement of Auditing Practice AUP 16, which is now called *The Auditors' Responsibility for Detecting and Reporting Irregularities Including Fraud, Other Illegal Acts and Error*, is effective from 31 December this year. Transactions highlighted in this statement include:

> related party dealings, transactions near balance date, excessive service payments, overseas tax haven deals, payment s to government officials and "evidence of unduly lavish lifestyles by officers or employees".[70]

In a related move, the Auditing Standards Board has also issued a brand new Statement of Auditing Practice AUP35 on *Communicating to Management on Matters Arising From Audit*. In this statement specific guidance is given to auditors on the steps to be taken in advising management and, where necessary, boards of directors. Significant matters that should be reported to the audit committee or board of directors include:

- a deficiency in the effectiveness of the internal control structure;
- irregularities, including fraud and other illegal acts;
- non-compliance with legislative, regulatory or contractual requirements.[71]

The Institute of Internal Auditors Inc. has addressed the issue of fraud in terms of the role and function of the internal auditor as follows:

> Fraud is a significant and sensitive management concern. This concern has grown in recent years owing to a substantial increase in the number and the size of the frauds disclosed. The tremendous expansion in the use of computers and the size of and publicity accorded computer-related frauds intensify this concern.
>
> The internal auditor's responsibilities for deterring, detecting, investigating, and reporting of fraud have been a matter of much debate and controversy. Some of the controversy can be attributed to the differences in internal auditing's charter from country to country and from organisation to organisation. Another cause of the controversy may be unrealistic expectations of the internal auditor's ability to deter and detect fraud.[72]

The Committee concludes that fraud exposure and fraud control are indeed a major concern for internal control processes and internal audit practices in Australia. The development of internal audit standards in Australia, as recommended by the Committee, should make it clear that within the public sector the internal auditor is management's first line of defence against exposure to fraud.

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[70] Cited in *The Australian Financial Review*, 22 April 1993, p. 12.

[71] Cited in *The Australian Financial Review*, 23 April 1993, p. 23.

[72] The Institute of Internal Auditors Inc., 1985: *Deterrence, Detection, Investigation, and Reporting of Fraud*, Statement on Internal Auditing Standards No. 3, May 1985, p.iii.

Department of Industrial Relations et al.

The Committee noted that fraud control plans are in place in many large government agencies. The Committee heard evidence from the Director-General of the Department of Industrial Relations, Employment, Training and Further Education on how his Department had addressed the issue of fraud and fraud control:

> Recently we issued a policy on fraud and corruption. The key thing we did was to get the policy in place. We made it clear who those people could report to and we kept reminding people on a regular basis what the provisions were.[73]

The Department's internal audit manager explained to the Committee how the fraud control plans were implemented as a part of the Department's total internal audit coverage:

> Following the Independent Commission Against Corruption Act we put in place a formal policy document that went out to all staff and that is included in the induction process. It is also touched on in the code of ethics. If anyone has a problem with corruption or fraud in the department or in any organisation he or she can report directly to the Director-General, to me as the contact officer, or to the ICAC if he or she believes that matter cannot be reported internally. So far we have reported 11 issues to the ICAC, but they have generally arisen form community complaints more than internal staff complaints.[74]

The Committee was pleased to note that the Auditor-General, in his 1992 Report to Parliament, had reported favourably on the action taken by the Department specifically relating to internal audit, internal control and fraud reporting mechanisms.[75] The Committee commends the Director-General for the positive steps taken in addressing fraud control within his Department and related bodies.

Auditor-General's special audit

A special audit of fraud control strategies within the public sector was undertaken by the Auditor-General and reported to Parliament in June 1993.[76] The Public Accounts Committee received a briefing from the Auditor-General on the principal findings of the audit, and received evidence from the head of a large government statutory authority included in the audit.[77]

The Commonwealth Auditor-General has used private sector estimates indicating that the fraud exposure in an organisation is likely to be in the region of 2% to 5% of turnover. Based on the mean of these private sector percentages, the potential for fraud in the New South Wales public sector could be as high as $1052 million annually without fraud control strategies being in place.

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[73] Minutes of Evidence, p.73.

[74] ibid., p.73.

[75] *New South Wales Auditor-General's Report for 1992*, Volume 2, p. 243.

[76] *New South Wales Auditor-General's Report for 1993*, Volume 1, pp. 11-20.

[77] Minutes of Evidence, pp. 228-230.

The Auditor-General noted that the Office of Public Management and the previous Auditor-General had also addressed fraud control issues. Using a sample of agencies from a previous OPM survey as a basis, the current Auditor-General found that 50% of 40 agencies surveyed had satisfied standards formulated by the Auditor-General's Office for fraud control, and a further 15% met a number of the standards but required enhancement of their fraud control strategies. The Committee was disappointed to note that 35% of the agencies were regarded as unsatisfactory, as their fraud control strategies required considerable development.

The audit results indicated that the New South Wales public sector may be exposed to a significant fraud liability, and that fraud control strategies of many agencies required considerable development. The audit also revealed the need for a more methodological approach to strategy development, which has led the Auditor-General to intend publishing a guidance document on fraud control strategies, and to progressively undertake a more detailed review of fraud control strategies across the whole public sector as part of the normal external audit function. The publication is to include an audit program which both internal audit managers and line managers could use as a guide for evaluating the adequacy of fraud control measures within their agencies.

One of the elements of the Auditor-General's survey was the conduct of risk assessment reviews in agencies. Such reviews involve line management identifying the possibility of fraud in high risk functions and taking appropriate counter measures to limit that risk. In this regard he found that 43% of agencies had not conducted such a review, and:

> Quite a few agencies tended to rely on the internal and external audit function for the achievement of this attribute. While these functions may be of considerable assistance, it is not sufficient to rely on audit progressively to review functional areas, even if the methodology is risk based. The auditor's responsibility does not extend to the prevention of fraud.[78]

The Committee was surprised that the Internal Audit Bureau submitted to the Committee that "The primary responsibility for detecting and investigating fraud lies with the internal auditor."[79] This view does not comply with any of the professional standards relating to fraud.[80] The Committee concludes that fraud control strategies are an essential component of a chief executive officer's internal control, and that a high priority focus of internal audit should be the review of the *adequacy* of those strategies.

The New South Wales Government has made major steps in prevention of fraud and corruption in this State's public service. The Committee believes that this progress could be enhanced if it was mandatory for internal audit to specifically review internal controls designed to prevent fraud, and was heartened when the NSW Treasury submitted that:

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[78] ibid., p. 18.

[79] S9, p. 17.

[80] AUP16 and SIAS No. 3.

> . . . the Treasury can see some benefit in making more explicit some aspects of the internal audit function e.g. review of fraud prevention and control policies and procedures and risk exposure.[81]

RECOMMENDATION 11

Fraud control strategies and systems should be made a top priority for review by internal audit. The Treasurer should make specific legislative provision accordingly, and the Treasury should ensure that this is appropriately covered by the internal audit standards to be developed in accordance with Recommendation 3.

ACCOUNTING MANUALS

The first term of reference for this inquiry is essentially about a review of s.11 of the Public Finance and Audit Act (see page 19), which provides for internal control and audit in government agencies. The general requirements for internal control are covered in s. 11(1), with internal audit covered in s. 11(2). Sections 11(3) and 11(4) cover the requirement for accounting manuals within agencies.

Under s. 11(3) of the Act the head of an authority is responsible for the supervision of preparation and maintenance of an accounting manual for use within the organisation. Section 11(4) clearly indicates that an individual agency's accounting manual cannot over-ride the provisions of the Act or the regulations.

Why an accounting manual?

The need for a manual to collect and maintain written statements of management policy has been fully realised as business systems become more complex and regulatory and reporting requirements place an increasing demand on directors and managers to achieve the highest level of corporate accountability.

The recent AWA case highlighted the responsibilities of boards of directors and management. In his interim judgement Justice Rogers noted:

> The Board of a large public corporation cannot manage the corporation's day to day business. That function must by business necessity be left to the corporation's executives.[82]

[81] S18, p. 1.

[82] Rogers J.: AWA Ltd v. G. R. Daniels trading as Deloitte Haskins & Sells & Others, Interim Judgement, 3 July 1992, p. 251.

Justice Rogers illustrated the relationship between boards of directors and management of a company in that directors rely on management:

(a) to carry out the day to day control of the corporation's business affairs,

(b) to establish proper internal controls, management information systems and accounting records,

(c) *to reduce to writing if appropriate and communicate policies and strategies adopted by the Board,* [emphasis added][83].

This judgement gives case law status to the concept of written instructions from top management on accounting policies and procedures and internal control systems within the organisation, including audit issues. This development in Australia can be compared with similar developments in the United States and the United Kingdom where separate studies have endorsed the responsibility imposed on management to establish sound systems of internal control that should be confirmed in writing and made available for all employees of the organisation.

In the United Kingdom, the Chartered Institute of Management Accountants (CIMA) is a professional accounting body with a special representation or membership of accounting professionals employed within companies and other business enterprises. The Law and Parliamentary Committee of the Institute has undertaken a study into internal control, internal financial control and the quality of control systems within a wide range of organisations.

In describing the elements of a typical system of internal control that can be applied in any organisation, the study group found:

> Clear responsibilities for, and accountabilities of, those involved in the various actions need to be set in written instructions and the arrangements need to apply throughout the organisation.[84]

In the United States, a study group drawn from professional, academic and commercial organisations and representing a wide cross-section of leading businesses,[85] reviewed the aspirations of senior executives as they seek to better control the enterprises they run. The study described the purpose of internal control as being the systems or functions input by management:

> . . . to keep the company on course toward profitability goals and achievement of its mission, and to minimise surprises along the way . . .[86]

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83 ibid., p. 253.

84 Law and Parliamentary Committee of the Chartered Institute of Management Accountants, 1992: *A Framework for Internal Control*, London, p. 12.

85 Committee of Sponsoring Organizations of the Treadway Commission (COSO).

86 Committee of Sponsoring Organizations of the Treadway Commission, 1992: *Internal Control—Integrated Framework*, Executive Summary, New Jersey, p. 1.

The study found that internal control means different things to different people. This can cause confusion among business people, employees, regulators and legislators. Within any organisation it is important for all people to carry out their responsibilities with full knowledge of internal and external requirements. The report of the study groups noted:

> Effective communication also must occur in a broader sense, flowing down, across and up the organization. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There also needs to be effective communication with external parties, such as customers, supplies, regulators and shareholders.[87]

In another Australian example, the report by Fergus Ryan into the Victorian Economic Development Corporation considered the absence of a comprehensive manual on policy and procedure. In his report Ryan noted that a "certain disjointed memoranda on practices and procedures" did not form what he would regard as an "acceptable policy and procedures manual".[88]

In his report, Ryan advocated the need for a board to have a "documented strategy" to control the risks and exposures of the business in the following terms:

> Policies and procedures are fundamental to the operations of any significant organisation. They are not only necessary for the sake of good order in the ordinary course of business but also form a foundation upon which people can fall back in difficult circumstances[89]

The Committee concluded that management should be responsible for implementing and maintaining adequate manuals documenting management policies for finance and accounting policies and procedures, internal control systems and policies and internal audit policies.

Audit cost-effectiveness

In the development and documentation of accounting systems, internal control processes and audit plans, it is important to recognise that internal controls and internal audits cost money. In planning and implementing internal control and internal audit processes management must recognise that the cost of a control should not exceed the risk exposure the control is designed to contain.

Properly documented procedure manuals can assist managers and auditors in assessing risk exposure, strengths and weaknesses in internal control systems, and the adequacy of audit processes.

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87 ibid., p. 3.

88 F. Ryan, 1989: *Report of Inquiry, Victorian Economic Development Corporation*, Victorian Legislative Assembly, Melbourne , p. 61.

89 ibid., p. 61.

The challenge to the internal auditor is to plan and document the audit process undertaken so as to present a defensible audit if the audit is later challenged by peer review or subject to critical review by a court.

The preparation and documentation of accounting and control manuals was discussed by Mr Justice Rogers in the AWA case.

> The need for preparation of the systems manual had another aspect as well. . . the nature of the . . . system would impact on the types of internal controls to be put in place. . . the nature and extent of internal controls would be set out in a manual as part of the construction of an accounting procedures manual. One would have to make cost benefit trade offs in deciding what sort of internal controls to introduce. They would have a relationship to the extent which particular employees at particular levels in the organisation were trusted. . . internal control rigour was a question of cost benefit for those undertaking the activity.[90]

Practice in NSW public sector

The Committee heard evidence from several agencies indicating that accounting and procedure manuals are used extensively in the public sector. The Department of Water Resources advised the Committee:

> We wanted an unqualified audit opinion, and as a result of that we put out a very extensive accounting procedures manual broken into sections . . .[91]

The Committee notes the action reported by the Department in addressing the external audit qualification matter. The Committee disagrees, however, with the motives behind the Department's development of an accounting manual. The Committee holds the view that accounting and other manuals should be developed to assist management at all levels, to implement sound systems of internal control, both financial and non financial, throughout the organisation. To focus on the avoidance of an external audit qualification is to understate the true value of control systems. All levels of management have a responsibility for certain operations, which includes responsibility for related control systems. Appropriate manuals should assist all members of an organisation to discharge their accountability obligations.

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90 Rogers J.: AWA Ltd v. G. R. Daniels trading as Deloitte Haskins & Sells & Others, Interim Judgement, 3 July 1992, p. 127.

91 Minutes of Evidence, p. 29.

RECOMMENDATION 12

Section 11(3) of the Public Finance and Audit Act requires government agencies to prepare accounting manuals, but this requirement is too narrow. The Treasurer should amend the legislation to *expand* the requirement for an accounting manual to include manuals covering accounting policy and procedures, internal control procedures (both financial and non-financial), and internal audit.

RECOMMENDATION 13

The NSW Treasury should develop, in conjunction with professional bodies, guidelines for chief executive officers and agency management generally on items to be included in the manuals referred to in Recommendation 12.

MANAGEMENT NEGLECT

The following are some examples where internal controls have been neglected by management, resulting in any or all of cost overruns, losses and corruption.

Private sector

In the case of AWA,[92] Justice Rogers wrote on the negligence of management in relation to internal control matters as follows:

- the failure to establish a proper structure of internal controls
- the failure to obtain and maintain an FX computer system at the outset and maintain a proper system of records of contracts and books and accounts for FX operations
- the failure to adequately supervise the activities of [the FX dealer]
- the failure of internal audit to carry out any adequate review of the FX operation and to follow up such defects and queries as it did raise
- the failure to report to the Board that there were inadequate internal controls and records
- [the General Manager's] failure to act on Daniels' warning that internal controls were quite inadequate

[92] See page 8 for background.

- [the General Manager's and the Internal Auditor's] failure, from June 1986 to act on Daniels' warning that it was essential that accounting procedures in relation to FX be improved forthwith

- failure of [the General Manager] et al. to act on the warning at the audit exit meeting in October and in particular [the Finance Manager's] failure to prepare an account manual.[93]

This case gives clear guidance to managers on the responsibilities that are placed on them as they administer a private sector company for a board of directors. The Committee views this as also a good lesson for public sector managers, keeping in mind that they are acting on behalf of the government, which in turn is accountable to the community through the Parliament.

In a later judgement, on the apportionment of damages, Justice Rogers addressed in positive terms the role of management as being:

> . . . it is for management, under the Board to carry on the business of the Company in the way it thinks best . . . It is for management to establish information and control structures.[94]

Roads and Traffic Authority

In the ICAC report on its investigation into driver licensing and allegations of corruption in the Roads and Traffic Authority (RTA), Commissioner Temby found:

> I accept . . . that apart from a small . . . retesting programs . . . and a partially successful attempt to develop the investigative arm of the internal audit branch . . . no positive steps of significance were taken to develop strategies and procedures to combat the corrupt practices which were known to be occurring in various motor registries with the . . . metropolitan area. Only a limited number of officers knew the extent of the problem, but one of them was the Commissioner for Motor Transport himself . . . The system in place had various negative features.[95]

In evidence to the Committee, the Acting Chief Executive and the Director of Finance and Performance Evaluation gave assurances that the RTA had improved internal controls and increased management awareness of internal control issues:

> In the RTA so far as the registries are concerned, there has been a significant strengthening of the management function, the management responsibility. Coupled with that . . . is a manager's control assurance program, which in basic simple terms is a document or checklist which enables the motor registry manager

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93 Rogers J.: AWA Ltd v. G. R. Daniels trading as Deloitte Haskins & Sells & Others, Interim Judgement, 3 July 1992, pp. 219-220.

94 Rogers J., 1992: p. 1652 in AWA Ltd v. Daniels trading as Deloitte Haskins & Sells & others (No. 2), *(1992) 10 Australian Company Law Cases 1643.*

95 Independent Commission Against Corruption, 1990: *Report on Investigation into Driver Licensing*, pp. 71-72.

> to identify those areas of internal control that need to be looked at on a regular basis. That manager can go through those controls and assess how his registry is performing and what needs to be undertaken. Coupled with that, there is a very strong commitment at senior executive management level from the chief executive downwards to the internal audit function.[96]

This commitment to internal control is certainly a step in the right direction. The Committee has one reservation, however, about the overall effectiveness of a documented or checklist approach to internal control. Effectiveness in this case depends on the contents of the checklist and the degree of compliance detected by the review. Rigid adherence to a widely distributed checklist could be counterproductive if it becomes a road map showing the way around controls.

In the course of the inquiry the Committee reviewed certain aspects of the RTA's DRIVES project which had received considerable media attention and was the subject of a special review by the Auditor-General and reported to Parliament in June 1993.[97]

In his report on the audit, undertaken at the request of the RTA, the Auditor-General made a number of comments and suggestions which could in the first instance be seen as a criticism of the RTA. In the long term, however, much can be gained from this review as DRIVES was a major project—one of the largest computer projects in the public sector in recent times. The Committee sees this review and the resultant public report as demonstrating a genuine attempt by the RTA to provide wide ranging disclosure on the project.

In discussing in broad terms the Auditor-General's report with the Committee, the RTA advised the Committee:

> **Mr Balding:** Mr Chairman, the Chief Executive requested the Auditor-General to undertake an initial audit of the DRIVES system before this report. This is the second time that we have got him in—not the Auditor-General coming in as the Auditor-General, but the Chief Executive engaging an external auditor to look at processing the system. It is not as if this was the first time the Auditor-General was here. It was just after the registration system. We requested the Auditor-General to do a special audit then to look at it for us and give management a report.
> **Mr Fisk:** I feel that this report by the Auditor-General's people tends to be twenty-twenty hindsight vision. They are saying, "If we started from scratch, knowing what we know now, we would do things in a different way." We all would probably do things in a different way. One has to look at the circumstances at the time. We were developing a major system. I do not know whether any members of the Committee have seen the report which appeared in *Information Technology Management*, a rather specialist publications, giving DRIVES a tremendous rap-up. It is really world class.[98]

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[96] Minutes of Evidence, p. 76.

[97] *New South Wales Auditor-General's Report for 1993*, Volume 1, pp. 41–47.

[98] Minutes of Evidence, p. 235.

In his report, the Auditor-General detailed a number of key findings:

- Many problems surrounded the replacement of the RTA's driver licence and vehicle registration systems at the time of an audit review in August-September 1992.

- The original estimates for the DRIVES project did not include all costs. As a result the initial budget was not met and progressive costs were not monitored against estimates at a detailed level.

- The quality control mechanisms in place did not identify all the weaknesses in the design phase.

- The initial specifications did not appear to identify all the business rules and conditions applicable to the system or allow for the extent of data errors in the old system.

- Some of the problems encountered were attributable to the computer illiteracy of staff and their not knowing how to deal with various situations.

- Transaction response times at motor registries have improved markedly after initial delays and would now appear to be satisfactory.[99]

When asked to make any general comments on the report, the Chief Executive of the RTA said:

> **Mr Fisk:** Yes. Again, this was an audit that we welcomed, and it is intended that there should be a follow-up from it. I think it is unfortunate that it took so long to publish because the sorts of comments being made about the DRIVES system really relate to the implementation phase of it, though at the bottom of the key findings it says, "Transaction response times at motor registries have improved markedly after initial delays and would now appear to be satisfactory." One reads criticism at first and then comes to the point that, in fact, the system is working damn well. It is an excellent system despite what some gentlemen, through prejudice borne out of ignorance, say about it. It is working well. It is a great improvement on anything this State has had before.[100]

The Committee followed up some of the issues raised by the Auditor-General in hearings with the Chief Executive and other senior officers of the RTA. A full transcript of the evidence has been tabled separately in Parliament. However, as this was not intended to be an inquiry into the DRIVES project, the Committee's concerns elaborated below relate specifically to the internal control and audit aspects of the project. In particular, the Committee was concerned with identification and quantification of cost overruns and the involvement of internal audit in reviewing the effectiveness of internal financial control within the project.

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[99] *New South Wales Auditor-General's Report for 1993*, Volume 1, p. 43.

[100] Minutes of Evidence, p. 230.

In this regard, the following exchange took place:

> **Chairman:** [to quote the Auditor-General] "it is impossible to report in any detail the areas where the overruns have occurred and why." That was very similar to some comments you made earlier, if I understood them correctly, that in fact it is impossible to pinpoint where the overruns were.
> **Mr Fisk:** Yes, because frankly we were there getting on with the job producing this system in the face of the imminent collapse of the system we were using. We were not obsessed with covering our backsides, which we would have had to have been to have given the level of detail that the Auditor-General was looking for. That would have required more people and it would have slowed the whole thing down. There was no wastage of money; there was no corruption of any sort in the letting of contracts or the controlling of payment to contractors, or anything like that. That was all rigidly monitored. But in terms of writing costs away and doing a thorough dissection on a moment to moment basis, no.
> **Chairman:** Is that the sort of thing that internal audit should be involved in?
> **Mr Fisk:** I think, generally, our accounting procedures are matters which internal audit looks at on a regular basis. If it had gone on long enough it probably would have been audited financially internally as well as on the system's basis. I stress that the EDP audit was separate and was thorough.[101]

The Committee was particularly concerned about the level of monitoring of project costs on an ongoing basis as an essential internal control:

> **Mr Irwin:** . . . I think you glossed over the question of whether project costs were discretely monitored to an acceptable level. In an exercise like this, whether you look at the $50 million or the $39.6 million plus the further $5.8 million on operating and enhancement, this is a major project by any standard.
> **Mr Fisk:** Indeed.
> **Mr Irwin:** For the Auditor-General to raise the point that the project costs were not discretely monitored, given the fact that because of the disruption to the whole of the agency—
> **Mr Fisk:** We had a bit of a quarrel with the Auditor-General at one stage over whether redundancy costs should have been charged to the project. We said they should not; the Auditor-General said they should.
> **Mr Balding:** Mr Chairman, may I clarify that point; the Auditor-General does not state that the projects were not discretely monitored; he said that they were not discretely monitored against progress at a detailed level. He is not saying that the costs were not monitored. The costs were monitored and they were reported through to the Chief Executive continually. I believe the Auditor-General is suggesting that they were not monitored for progress against various milestones and they could have been monitored in greater detail. I just want to make it very clear that the costs were monitored.
> **Mr Fisk:** In part, this is due to the fact that the goal-posts were being moved as we went along as we found things out about the existing system, as we had the problem with the CASE tool. That changed our goal-posts.
> **Mr Irwin:** I can appreciate that it changes the goal-posts but if that is occurring, it would make them more relevant. Given the experience of agencies with the

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[101] Minutes of Evidence, p. 235.

> introduction of a computer based system, from an internal point of view at least should that not require discreet monitoring?
> **Mr Fisk:** I do not think it is a question of internal audit: I think it is a question of accounting. What you are saying is: should we not have been accounting on a discrete basis?
> **Mr Irwin:** Should your internal audit be telling you, as the Chief Executive, that something is going on that you should know more about than you actually do?
> **Mr Fisk:** Internal audit cannot cover the whole organisation all the time. It would not be auditing if it were. If you like, auditing is a snapshot which is taken periodically in different parts of the organisation. It is a spotlight turned on here or there. Allan Waldon [General Manager of the Internal Audit Branch] cannot tell me what is going on throughout my organisation at any moment. He can say that he has looked at a particular area and that he has found it deficient or that everything is adequate, but he cannot talk about some other part of the organisation that he is not looking at and he cannot look at everything without employing a vast army of auditors all the time.[102]

The Committee noted that, as stated in the Auditor-General's report, the internal controls of the DRIVES project have yet to be subject of a detailed post-implementation review. In that regard, the following exchange took place:

> **Mr Irwin:** The Auditor-General stated in his conclusion that it is his intention shortly to review the adequacy of internal controls. Are you satisfied that the internal controls you have in place with the DRIVES system will meet the requirements of the Auditor-General?
> **Mr Fisk:** Because I do not know what the requirements of the Auditor-General are I would hesitate to put my hand on my heart and say yes. But I am pretty satisfied with the internal controls. . .[103]

The Committee does not consider it to be appropriate to draw any definite conclusions at this stage. In saying this, however, the Committee does express concern at the apparent lack of internal control of the financial aspects of the DRIVES project. The Committee holds the view that in managing the control and expenditure of public funds, the highest level of control should be maintained at all times. Appropriate budgetary controls or "milestones", to quote the RTA, should be established in any major project as an essential component of project management. If cost milestones *are* in place, then it is ultimately an easier task for internal audit to monitor a project's internal controls, precisely because there is something for internal audit to compare actual expenditure against.

This is one of the basic attributes of internal control and is most appropriate for the public sector.

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[102] Minutes of Evidence, pp. 240–241.

[103] Minutes of Evidence, p. 242.

Police Service

In 1982 the Committee inquired into management and control aspects of police overtime. The increasing cost of overtime had prompted the then Premier and Treasurer to write to the Commission of Police and stress the:

> need for continuous and effective monitoring procedures to ensure that this major cost item is controlled to the maximum extent practicable.[104]

In a follow-up report in 1986, the Committee noted an apparent lack of progress made since 1982, and was hampered during the inquiry by a lack of reliable data. The Committee made the following observation:

> The Committee is critical of the lack of action on sick leave by Police management. The Committee considers that monitoring and control of sick leave is a management responsibility. Control by management over this area undoubtedly provides a good indication of the quality of management in other areas.[105]

The Committee recommended that steps be taken to improve the way in which sick leave is monitored and controlled.

In the current inquiry into internal audit, the Police Service asserted that internal control systems within the Service have improved. The Committee was advised:

> **Mr Abraham:** . . . our finance reporting system can provide us with many of those statistics up-front and we would know exactly where each group district or even patrol; compare patrol to patrol outside districts and outside regions so, yes, they are useful to us . . .
> **Mr Brown:** Another aspect of internal control apart from internal audit is our direct line management responsibility where if a commander of a patrol, district, region or any other area of the New South Wales Police Service on a monthly basis, their budget performance or actual expenditure against budget is plus or minus more than 5 per cent, then they are required to submit a report as to why that variance has occurred and what they are going to do about it to bring it back within budget by the end of the year.[106]

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104 Public Accounts Committee, 1982: *Overtime Payments to Police*. Report No. 5, p. 13.

105 Public Accounts Committee, 1986: *Follow-up Report on Overtime, Sick Leave and Associated Issues in the New South Wales Police Service*. Report No. 28, p.24.

106 Minutes of Evidence, p. 67.

London Office of the Agent-General

A case of weaknesses in internal controls has come to light very recently through the Auditor-General reporting to Parliament on an audit of the London Office of the NSW Agent-General.[107]

The London Office of the Agent General is an outpost of the Department of State Development. The Agent-General was accountable directly to the Director-General of that Department.

The audit was conducted following allegations in parliamentary Estimates Committee hearings that the Agent-General had disregarded directions relating to travel. The audit found that the Agent-General had "consistently confused private and public expenditures",[108] and bought items and services for private use out of public money. Although the Agent-General indicated an intent to repay amounts owing to the State, "the total sum of money owing is likely to be sizeable".[109] Available information showed that private or unauthorised expenditure from public money amounted to £20,000, plus a further amount of at least £10,000 subject to further inquiry.[110]

The Agent-General was also found by the Auditor-General to have appointed staff without merit selection and contrary to instructions of his superiors, exceeded delegated expenditure authority on capital works, travelled without approval and contrary to directions, and authorised a private sale of an official motor vehicle to a friend.

The Auditor-General concluded that "There was, as is clear, a lack of effective internal control." To overcome this problem, he suggested that "the Department consider the benefit of regular internal audit scrutiny of the details of its Tokyo and London offices' expenditure. Alternatively, the Department could consider establishing a reporting mechanism that requires the offices' accountants to raise directly with the Head Office the detail of abnormal expenditures where advice or another opinion would be useful."[111]

The Committee notes, however, that many of the Auditor-General's conclusions are disputed by the former Agent-General in an arbitration between himself and the New South Wales Government which is currently being heard.

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[107] New South Wales Auditor-General, 1993: *Report of an Audit into the London Office of the Agent-General Under the Tenure of the Honourable Neil Pickard.*

[108] op. cit., p. 6.

[109] ibid., p. 9.

[110] ibid., pp. 63-64.

[111] ibid., p. 8.

TAFE Commission

The Technical and Further Education (TAFE) Commission underwent major restructuring in 1991 and 1992 which involved devolution of central support responsibilities for personnel, staffing, purchasing, stores, records and administration. The Auditor-General has reported shortcomings in internal controls for several years.[112] He noted that little if any progress was made in 1991-92 on the resolution of matters previously raised, mainly due to the Commission's focus on decentralisation of accounting processes, changing organisational structure, and implementing then solving problems with a new computerised financial management system. In addition, internal audit's planned level of coverage was not achieved because of the need to apply resources to fraud investigations.

The Auditor-General also noted that the Commission has since focussed attention on matters of concern arising from the audit, and it looks as though satisfactory remedial action is underway on the majority of matters.

However, there still seems to be uncertainty about the adequacy of the internal control environment at institutes and their constituent colleges and campuses, particularly relating to non-payroll expenditure. The Auditor-General noted that:

> This is of major concern given the devolution of centralised functions and responsibilities that has occurred with restructuring.[113]

CONCLUSION

Accountability problems in motor registries, handling Police overtime and sick leave, the London Office of the Agent-General and the TAFE Commission illustrate that CEOs of decentralised agencies with distributed responsibility need to pay particular attention to ensuring effective internal controls in regional offices, even those overseas, where staff sometimes perceive that they have greater freedom. When responsibility is devolved, the accountability requirements remain unchanged.

The Committee believes that the need for management to have an effective system of internal controls cannot be stressed strongly enough. How can we then ensure this?

First of all, chief executive officers need clear statutory direction. The Committee agrees with a suggestion from the Internal Audit Bureau that legislation relating to internal controls should make it clear that the whole agency should have appropriate internal controls.[114] Section 11(1) of the Public Finance and Audit Act requires "an effective system of internal control over the financial and *related operations* [emphasis added] . . ." Although the section goes on to mention that there should be "sound practices for. . . each organisational branch or section . . .", it is not clear that there should be effective internal control over *all* operations of the agency.

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112 *New South Wales Auditor-General's Report for 1993*, Volume 1, pp. 197-198.

113 ibid., p. 198.

114 S9, p. 10.

Secondly, as it is apparent that legislation can be effectively ignored, the Committee feels that the CEO's responsibility for effective internal control can be asserted unequivocally by making it a standard part of all performance agreements with CEOs. The CEO would then have to directly answer for any problems in internal control, and this would certainly encourage some CEOs to take internal control and audit much more seriously than at present.

Responsibility for chief executive performance agreements lies with the Premier's Department. The Committee notes that Premier's Department Circular No. 93/4 on guidelines for chief executive performance agreements suggests that key accountabilities of the general management agreement should focus on issues such as "internal planning and review". Under this heading, the sample agreement lists one possible key accountability as "ensure the establishment and maintenance of adequate internal controls and reporting systems", with an appropriate performance indicator being "Satisfactory internal and external audit findings of the operation of the financial management information systems". The Committee firmly believes that this is a step in the right direction, but sees no reason why all CEOs should not have internal control always specified in their agreements.

The third part of the answer lies chiefly with internal audit itself, which is arguably the most important component of internal control, and the focus of this report. The need for internal audit is the subject of the next chapter.

RECOMMENDATION 14

Chief executive officers of agencies must set in place appropriate internal controls covering *all* parts and operations of their agencies, and any doubt about this should be removed by the Treasurer with appropriate amending legislation.

RECOMMENDATION 15

The performance agreements of chief executive officers should include effective internal control as a key accountability, with appropriate performance indicators and performance targets, and the Premier's Department should take all necessary steps to ensure that this is done.

CHAPTER 5: MANAGEMENT RESPONSIBILITIES FOR INTERNAL AUDIT

DECIDING LEVEL AND BEST METHOD OF INTERNAL AUDIT

When is internal audit not required?

The Public Finance and Audit Act requires a chief executive officer to establish an internal audit function *wherever practicable.* As pointed out to the Committee by a representative from the Department of Health (see page 70), *wherever practicable* is not defined.

Previous Committee view

This point was discussed in Report No. 15, where an inconsistency was exposed between the legislation clearly providing for *discretion* in establishing an internal audit function, and the then NSW Treasury guidelines interpreting the legislation as providing for *mandatory* internal audit.[115]

It was the Committee's view then, as it is now, that internal audit is an integral part of a chief executive officer's system of internal controls. There is no question that the legislation provides a mandatory requirement for a chief executive officer to establish an effective system of internal controls. In 1985, the Committee felt that the intent of the legislation was to allow a chief executive officer to use discretion in determining the appropriate level of internal audit within the system of internal control. Indeed, the Committee pointed out that:

> It is arguable that the phrase "wherever practicable" in the Public Finance and Audit Act, permits that the head of an authority could rightly decide, in the interests of economy, not to maintain an internal audit or other internal performance review function, provided he/she was satisfied and could demonstrate to any external function that there existed:-
> (a) a sound structure of objectives, organisation, management delegation and resources;
> (b) an effective and comprehensive system of internal controls;
> (c) adequate management information reporting systems to enable performance to be measured and monitored on a timely basis for decision making before adverse trends become material.[116]

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[115] op. cit., p. 58.

[116] ibid., p. 59.

Nonetheless, the Committee recommended:

> That Section 11(2) of the Public Finance and Audit Act be redrafted to clarify that the head of an authority is responsible for ensuring the performance of the functions outlined in the legislation but that the organisational form of the internal audit function be left to the discretion of management.[117]

The Committee now notes that no action was taken on this previous recommendation. As a consequence, s. 11(2) of the Act still appears to cause concern, according to evidence collected by the Committee during this inquiry.

Current situation

The current NSW Treasury guidelines on internal audit shed no light on what is *wherever practicable*. In their submission, Ernst & Young claimed that "It would seem to us difficult to conceive of a situation where an authority could be without an internal audit unit on the basis it was not practicable."[118]

The Department of Health is the largest single government agency in the NSW public sector and has a complex management structure which includes area health services, public hospitals, publicly funded private hospitals, and an ambulance service. In evidence to the Committee, the Director-General and the Director of Internal Audit explained that the Department also has a complicated matrix structure of internal audit, with a separate internal audit group for any unit with a budget over $20 million per year (which includes the area health services and some individual hospitals), regional internal audit groups, and a corporate head office internal audit unit.[119] The complexity is due to a large extent to the area health services being separate bodies with their own boards of management.

It was not surprising that the Director of Internal Audit told the Committee that:

> I think that "practicable" needs to be defined as that causes a lot of confusion in the public sector. I think it should be mandatory for any substantial public sector organisation to have an internal audit unit.[120]

Speaking at the Committee's seminar, the Auditor-General said:

> . . . section 11 of that Act requires that the head of an authority establish wherever practicable an internal audit unit. It is a legislative requirement. It is not clear why the legislation envisages that an internal audit area might not be practicable. I cannot think of many organisations, and we audit 450 of them annually, where some internal audit presence is impracticable. Even very small organisations can afford to have a part-time officer or an external part-time

117 ibid., p. 60.

118 S5, p. 3.

119 Minutes of Evidence, pp. 102–103; as well as response to the survey of internal audit.

120 Minutes of Evidence, p. 103.

> consultant or a suitable officer who has other duties as well as internal audit functions.[121]

(However, in later hearings and in written evidence, the Auditor-General explained that he provided extended external audit services to some agencies in place of internal audit.)

The Director of Financial and Performance Evaluation of the Roads and Traffic Authority agreed with the Auditor-General as follows:

> . . . and I would suggest the Act does need some strengthening. I think the words "wherever practicable" should be deleted. . . Now, I think it should be mandatory upon the chief executive to establish and maintain an effective internal audit.[122]

In a public hearing before the Committee, the Auditor-General suggested:

> I think that I would still prefer to have the onus on the organisation having the internal audit unless it applies and is exempted.[123]

An advantage of this, according to the Auditor-General, is that on application for exemption from the need to have internal audit:

> the Treasurer or whichever body is going to be responsible for the exemption can indicate that you can indeed have an internal auditing function reasonably cheaply by hiring an external auditor, not full time but on a part-time basis, four meetings a year basis.[124]

In any event, the Auditor-General maintained that:

> There are a large number of big agencies where the internal audit process is not up to scratch and getting rid of the words "wherever practicable" and outlining with more legislative force the kind of internal audit presence that ought to be there could be useful.[125]

The Public Finance and Audit Act imposes the same requirements on large departments such as the Department of Health and large statutory authorities such as the Water Board (annual revenue of $1.3 billion), as on the Processing Tomato Marketing Committee of New South Wales with a total revenue of $500 (and an external audit fee of $200).

Weighing up all of this evidence, the Committee feels that there must be some point where it becomes impracticable to have a separate internal audit function. The Committee can see considerable merit in the Auditor-General's suggestion to provide for exemptions. We are sure that some very small, low risk agencies that satisfy certain criteria acceptable

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[121] Public Accounts Committee, 1992: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, p. 71.

[122] Minutes of Evidence, p. 82.

[123] ibid., p. 151.

[124] ibid., p. 151.

[125] ibid., p. 151.

to the Treasurer could probably justify not having an internal audit function, but the mere function of applying for an exemption would enable the Treasurer to advise on an appropriate level and type of internal audit.

RECOMMENDATION 16

The statutory requirement for a chief executive officer to establish an internal audit function *wherever practicable* must be strengthened. The requirement to establish an internal audit function should be *mandatory*, subject to specific and limited exemptions. The Treasurer should amend the legislation accordingly, including provision for a new schedule of exemptions.

RECOMMENDATION 17

There will therefore need to be criteria against which applications for exemption from internal audit can be assessed. The NSW Treasury should develop such criteria, and these should address the ability of the chief executive officer to ensure that proper systems of internal control are maintained over all operations of the authority without the need for a separate internal audit function.

RECOMMENDATION 18

The NSW Treasury should maintain the new schedule of exemptions by assessing applications by agencies for inclusion on the schedule against the exemption criteria. Where an agency satisfies the criteria, final approval for inclusion in the schedule should rest with the Treasurer.

RECOMMENDATION 19

In his annual external audit of government agencies, the Auditor-General should review those agencies on the schedule of exemptions with regard to the appropriateness of their continued listing on the schedule. Recommendations for removing agencies from the list should be made to the Treasurer. The NSW Treasury should assess such recommendations against the exemption criteria. Where an agency is determined to no longer satisfy the criteria, final approval for removing an agency from the schedule should rest with the Treasurer.

Extended external audit

One of the most controversial issues of this inquiry was an allegation by the Internal Audit Bureau that the Auditor-General was providing the internal audit function to several agencies for which the Auditor-General was also conducting the external audit. In this way the objectivity and independence of the Auditor-General was said to be compromised in regard to the Auditor-General's reporting responsibilities to Parliament. The Director of the Bureau felt so strongly about this that one of the two key recommendations made in the Bureau's submission was that the Committee review the role of the Auditor-General with regard to the provision of internal audit and related services with a view to the Auditor-General ceasing this role.

The provision of both internal and external audit services to an organisation by the same auditor was addressed in the Committee's seminar. In this report, the matter is covered later in this chapter (page 106). However, in following up the Bureau's allegation and recommendation, the Committee heard evidence that, with one special exception, the Auditor-General was *not* providing both internal and external audit services to agencies.

Briefly, the Committee understands that the *internal audit and related services* the Bureau is concerned about comprise, according to the Auditor-General:

- secondment of staff from the Audit Office to agencies to assist with development of internal audit functions and other internal controls
- provision of advice on internal audit and other internal controls resulting from the external audit
- extended or expanded external audit
- internal audit of the ICAC.

It is difficult for the Committee to exclude the possibility that the perception of the Auditor-General competing for services with the Internal Audit Bureau is a motivation for the Bureau's submission.

The secondment of staff, provision of advice, and internal audit of the ICAC are discussed later in this chapter in regard to whether or not internal audit and external audit should be able to be conducted by the same organisation. The issue of an extended external audit is more closely related to the level and method of internal audit, and requires a management decision.

The Committee's understanding of an extended external audit[126] is as follows:

- All agencies must have their financial and related operations (externally) audited by the Auditor-General so that the Auditor-General can form an opinion on the financial statements.
- The external audit must review the quality of the internal control systems. In doing so, account can be taken of the results of the internal audit, which also evaluates the other internal controls.
- During the external audit, the more an internal audit is found to be effective, the less work has to be carried out in evaluating the other internal controls. No matter

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[126] Based on Minutes of Evidence, pp. 140–144, and SO, p. 3.

how good the internal audit was found to be, there is always some requirement for external audit to evaluate the other internal controls. This is normal practice in external auditing, and is consistent with Australian professional auditing standards and practices.

- To the other extreme, if the internal audit was found by the external audit to be completely unreliable, or if there is no internal audit (as the Committee has argued above could be appropriate in some circumstances), then the external audit must conduct a *full* evaluation of the agency's internal controls that relate to the agency's financial statements.
- If a decision is made up-front by the chief executive officer to not have an internal audit function (and an exemption is granted by the Treasurer in accordance with Recommendation 18), then the Auditor-General must make an up-front decision to conduct a full external audit. This is an *extended* external audit.

The Auditor-General explained that there is an inverse relationship between the quality of the internal audit and the amount of work that has to be carried out during the external audit to enable an opinion to be given on the financial statements. The Committee notes that this is in accordance with the provisions of the Public Finance and Audit Act relating to the duty of the Auditor-General, and is also in accordance with Australian professional auditing standards and practices. Section 34 of the Act states that:

> The Auditor-General shall audit the Public Accounts and any other accounts as the Auditor-General is authorised or required to audit in such manner as the Auditor-General thinks fit having regard to the *character and effectiveness of the relevant internal control* and *recognised professional standards and practice* [emphasis added].

The Australian Accounting Research Foundation's Auditing Practice Statement AUP2 on *Using the Work of an Internal Auditor* clearly points out that:

> An adequate and effective internal audit function will often justify a reduction in the extent of procedures performed by the external auditor, but cannot eliminate them.

The IIA's standards address the need for regular evaluations of the co-ordination between the two audit functions, particularly in regard to total audit cost:

> These evaluations may also include assessments of overall efficiency of internal and external auditing, including aggregate audit cost.[127]

The Auditor-General charges on the basis of the amount of work conducted, so as the quality of internal audit increases, the Auditor-General's fee decreases. (This was indirectly confirmed by Johnston in his submission[128], although the Director of the Internal Audit Bureau maintained that external audit fees were fixed and set before the

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[127] The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, 550.01.5, Altamonte Springs, Florida, p. 50.

[128] S3, p. 4.

audit, and he "did not know of any case where the fee is reduced because of excellence in internal auditing."[129])

The agencies for which the Auditor-General has conducted or is conducting extended external audit in place of an internal audit function relating to the financial statements are the State Sports Centre, the Meat Industry Authority, the New South Wales Crime Commission, the Cobar Water Board, and the Broken Hill Water Board.[130] These are small and sometimes isolated bodies with narrow ranges of operation.

It comes down to a management decision on a cost-benefit basis about how best to carry out the internal audit function. In accordance with the discussion above on the practicability of a separate internal audit function (page 71), the Committee concludes that the approach taken by the chief executive officers of these bodies in using extended external audit services in place of a mix of internal and external audit is most economical and does not compromise the objectivity and independence of the Auditor-General.

To alleviate the apparent concerns of the Internal Audit Bureau, the Committee reiterates its Recommendation 18 that when an extended external audit by the Auditor-General is contemplated by a chief executive officer—that is, in place of an internal audit function—then a specific exemption must be obtained from the Treasurer. The Committee expects that each agency listed on the proposed schedule of exemption from internal audit would be subject to an extended external audit.

Of course there is nothing to stop the Internal Audit Bureau marketing its internal audit services to those agencies on the proposed schedule of exemption. The final decision about the appropriate level and method of internal audit should be made by the chief executive officer, in full knowledge that he/she is accountable for the outcome of that decision.

Outsourcing internal audit

Contracted out vs in-house staff

The Public Finance and Audit Act implies that a chief executive officer should establish an internal audit function within the agency—that is, a truly in-house internal audit staffed by employees of the agency. Since that Act came into being, there has been a trend towards contracting out, or outsourcing of non-core services in government agencies, not only in New South Wales, but around Australia as well as in the United Kingdom, the United States and New Zealand.[131] Government policy to contract out as many services as possible arises from a perception that the private sector can provide these services more efficiently and just as effectively. The policy is generally implemented through cuts in

[129] Minutes of Evidence, p. 125.

[130] S15.

[131] D. Nicholls, 1991: *Managing State Finance: the New South Wales Experience*. NSW Treasury, p. 78. Contracting out involves using the services of another organisation, so that the services are provided by employees of that organisation rather than the agency. Note that *contracting in* is another term meaning the same as *contracting out* or *outsourcing*.

staff establishment numbers, which forces agencies to focus their staff on core functions. The types of non-core services targeted for contracting out have included cleaning, computer services, printing, legal services, mechanical engineering, and internal audit.

Middleton pointed out that "Unfortunately, some chief executives see internal audit as an expenditure item or at best an activity that should be minimised."[132]

Having an in-house internal audit function could have many advantages over contracting out the function, including:[133]

- Provides a unique training ground for future managers.
- Less cost (no profit margin).
- Provides a more stable function.
- Staff have better knowledge of agency's business, plan, structure, etc.
- Staff have more commitment and loyalty to the agency.
- Staff are more flexible, and more often available.
- Better rapport with other staff of the agency, who are colleagues.
- Better security with regard to confidential information.

However, except for the first one, these advantages of in-house internal audit could also be said to apply to contracted internal auditors—it really is just a matter of perception.

It is therefore difficult for the Committee to recommend either in-house or contracted out internal audit. The decision is rightly the responsibility of the chief executive officer, who could obtain guidance from an audit committee, or from the external auditor. In realising this, the Committee has instead considered ways of ensuring that chief executive officers obtain the best value-for-money out of their internal audit, regardless of the structure used.

There are some particular occasions in which a chief executive officer might consider using contract services for internal audit:[134]

- To assist establishing an in-house internal audit function.

- The agency is too small to have a full-time position.

- When specialist skills or extra resources are temporarily required.

- When total audit costs are considered too high.

- To assess quality of the in-house function.

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[132] B. Middleton, 1993: *Contracting out the internal audit function.* Paper presented at the IIR conference on *Internal audit and control—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney, p. 3.

[133] ibid., many of the stated advantages were raised during discussion..

[134] ibid., p. 4.

Perhaps the best approach for a chief executive officer is to keep an open mind on in-house and contracted out internal audit, and to use a combination if the agency is large enough. This provides for flexibility and the opportunity to obtain a good mix of skills. In such cases, an in-house internal auditor could manage the contractors, but there would be potential for a skills transfer from the contractors to in-house internal audit staff.[135] The overriding concern is that the amount and type of internal audit that is required is going to be determined by the chief executive's perception of risk, rather than on the dollar value available for internal audit once everything else is provided for.

Private sector input to public sector internal audit skills

The Committee received advice that in the private sector, internal audit units typically include multi-disciplined teams or specialist skills. The Group Manager for internal audit in the AMP Society advised the Committee:

> Going back to the AMP Society we tend to specialise our internal audit within Australia. We have split it into three units to accord with the AMP's business units, namely personal insurance, superannuation, and investments. The reason for that is that superannuation has become terribly complex, and so has investments. So you must have adequate skills to be able to audit those functions.[136]

The Department of Water Resources gave evidence to the Committee that a mixture of staff and contract internal auditors from the private sector has been used to address the complex auditing issues involved in a public sector body undergoing rapid change with conflicting demands to reduce overall staff numbers. The Director-General advised the Committee:

> Prior to us going to contract there was a concern to me that we were not able to put enough resources into both compliance auditing and management auditing and we tried a whole different range of approaches over the last five years. I was never content that we were actually able to provide the right input.
>
> One of the advantages of going to contract is that those contractors are focussed on a particular job. When our internal auditors would go out to do a particular job for say, compliance auditing, they would be drafted off into a bit of management auditing over here and I don't think it ever quite achieves that focussed purpose.
>
> What we are now able to do, seeing that the compliance auditing is focussed with the contractor, we are able to use our own people on a broader range of things in management auditing that we haven't been able to do.[137]

The Committee was further advised that contracting internal auditors from public accounting firms resulted in acquiring specialist financial auditing skills that are difficult to both obtain and retain in a relatively small internal audit unit:

[135] S2, p. 3.

[136] Minutes of Evidence, p. 9.

[137] ibid., p. 159.

> They also have a wide range of resources to draw on, different skills within their own firm that they can apply to, and have done, to the nature of particular types of audits that we like to have conducted. In that sense—I wouldn't want to make comparisons of individuals and say that any individual would necessarily be superior, but just using that approach, engaging one of those top firms to do the work, has given us that broader experience to draw on.[138]

The Committee concludes that in developing plans to equip internal audit with the necessary levels of skills and competence required, a chief executive officer needs to consider the qualifications and experience of staff resources, and the relative efficiency of contracting-in specialist skills from outside the organisation.

Selecting and managing contractors

Middleton[139] argued that internal audit contractors are just like any other type of contractors in that they can be engaged and managed using the same principles. The Office of Public Management has issued *Guidelines for the Engagement and Use of Consultants*, and these guidelines should be used.

For monitoring the effectiveness of contracted internal audit services, the use of questionnaires can be useful. More on assessing the quality of audit is presented below.

RECOMMENDATION 20

There are many advantages of contracting-in internal audit services, but internal audit contractors need to be properly engaged and managed as for any other type of contractors. The NSW Treasury should amend the guidelines on internal audit to advise that chief executive officers who contract-in internal audit services should use the Office of Public Management's *Guidelines for the Engagement and Use of Consultants* for the selection and management of those services.

Using in-house audit staff

As mentioned on page 75, s. 11(2) of the Public Finance and Audit Act could easily be interpreted to require a chief executive officer to establish an in-house internal audit unit. One of the terms of reference for this inquiry is to consider the minimum size necessary for an in-house internal audit function.

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138 ibid., p. 161.

139 B. Middleton, 1993: *Contracting out the internal audit function.* Page 6 in paper presented in IIR conference on *Internal control and audit—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney.

The IIA—A advised that "The minimum size is totally dependent on the organisation facets such as risk assessment, number of locations, nature of business operation, degree of computer sophistication, audit charter responsibilities and cycle."[140]

On page 71 the Committee made reference to comments by the Auditor-General, who felt that even very small agencies could have a part-time internal auditor, either on-staff or contracted in. Deloitte Ross Tohmatsu—one of the six largest international accounting firms and one of the largest providers of contract internal audit services to the New South Wales public sector—noted that "We are aware of many private organisations with an effective internal audit function of one person. . . we believe that many organisations do benefit from having at least one full time member of staff dedicated to internal audit."[141] The Committee interprets these comments as meaning that there really is *no* minimum size necessary for an in-house internal audit function.

The Internal Audit Bureau, or at least its Director, provided an alternative view:

> When the Internal Audit Bureau was established by the NSW Treasury it was considered by Treasury that internal audit sections of three people or less would prove not to be viable because of:
>
> - inappropriate grading
> - inappropriate structure
> - inadequate career path to attract the right applicants in the first place
> - inadequate skill mix to be able to effectively cover the full range of audits that would present themselves.
>
> In line with that policy, the Internal Audit Bureau was formed to provide an internal audit service to those organisations which fell into that category and who decided that they preferred to contract out the function.[142]

The Committee sees merit in using wholly outsourced internal audit, wholly in-house internal audit, and combinations, according to the nature of an agency's operations as perceived by the chief executive officer. The Committee does not wish to prescribe how a chief executive officer allocates the internal audit. In fact, the Committee agrees with its forbearers of 1985 that the legislation should clarify that it is the responsibility of the chief executive officer to ensure that the functions of internal audit are carried out by whoever the chief executive officer thinks will provide the most economical, effective and efficient internal audit service. In making that decision, the chief executive officer can obtain advice from the Auditor-General, the audit committee, the NSW Treasury, and from internal audit consultants, including the Internal Audit Bureau.

This is consistent with s. 35 of the Public Finance and Audit Act which provides the Auditor-General with the power to appoint a person or a firm to be an auditor for the purposes of the Act. In practice, the Auditor-General has contracted out whole audit

[140] S6, p. 15.

[141] S11, p. 9.

[142] S9, p. 15.

engagements and obtained under contract specialist audit expertise in areas such as treasury, taxation, information technology audit, and staff training.[143]

RECOMMENDATION 21

There is merit in using wholly outsourced internal audit, wholly in-house internal audit, and mixtures, according to the nature of an agency's operations and the need to obtain an economical, efficient and effective service. In its 1985 report on performance review practices in the New South Wales public sector, the Public Accounts Committee made a recommendation that has not yet been implemented. That recommendation is reiterated in the current report: the Treasurer should amend the legislation to clarify that the chief executive officer is responsible for ensuring the performance of the functions outlined in s. 11(2) of the Public Finance and Audit Act, but that the organisational form of the internal audit function—that is, whether it is conducted in-house and/or contracted out—should be left to the discretion of management.

INTERNAL AUDIT CHARTER

To be effective, internal audit needs the support of senior management, including clear signals from management throughout the agency about the importance of the audit process.

Management should prepare and distribute a written policy statement on the role and function of internal audit within the agency. This statement is commonly known as the internal audit charter. Management responsibility to approve and promulgate an internal audit charter is addressed in the NSW Treasury guidelines on internal audit.

The IIA's standards advocate a written document or charter for internal audit in the following words:

> 4. The purpose, authority, and responsibility of the internal auditing department should be defined in a formal written document (charter). The director should seek approval of the charter by management as well as acceptance by the board. The charter should (a) establish the department's position within the organisation; (b) authorise access to records, personnel, and physical properties relevant to the performance of audits; and (c) define the scope of internal auditing activities.[144]

In evidence to the Committee this concept of a written internal audit charter was supported by a representative from the Institute of Chartered Accountants in Australia:

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143 Auditor-General's Office, 1993: *Annual Report for the Year Ending 30 November 1992*, p. 21.

144 The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, 110.01.4, Altamonte Springs, Florida, p. 10.

> . . . training, qualifications, and a code of ethics, together with an appropriate internal charter, are better than an insurance policy.[145]

Ernst & Young advocated an internal audit charter which documents the roles and responsibility of internal audit, separate from an internal audit policy statement,[146] but the Committee sees no real need for this separation.

In its internal audit survey, the Committee found that most agencies indeed had formal internal audit charters. One example, however, was found where the charter was out of date with organisational restructuring.

Even when internal audit is contracted out, either partly or wholly, it is imperative for the internal audit charter to clearly establish responsibilities between contracted services, in-house or staff services, and agency management.

The Director-General of the Department of Industrial Relations, Employment, Training and Further Education advised the Committee that a revamped internal audit operation had overcome some earlier problems encountered by the Department:

> We recruited some new staff and established an internal audit charter for the Department which was public and made available . . . it was to give the internal audit unit not just a policeman type role but an education role . . . raising the level of awareness and importance of the audit committee and the internal audit theme and, secondly, the educative role to prevent problems before they become issues.[147]

A similar view was put to the Committee by the Director-General of the Department of Sport, Recreation and Racing:

> We do have an Internal Audit Charter . . . we have established an Audit Committee. . . It is responsible for the preparation of the internal audit charter to receive and review audit reports, provide full comment, thereon, resolve any problems or difficulties in the effective operating of the audit function.[148]

The Committee endorses these comments and is of the opinion that the internal audit charter should be a clear reflection of management's attitude to internal control and audit.

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[145] Minutes of Evidence, p. 18.

[146] S5, p. 5.

[147] Minutes of Evidence, p. 68.

[148] ibid., p. 171.

Internal audit capability statement

The conventional model for internal audit coverage within an organisation is for the CEO or board to grant an audit charter and for the manager of internal audit to respond by preparing short and long term plans for approval by the CEO or board.

As an expansion to this process, the Committee considers that internal audit managers should prepare a capability statement for internal audit based on established accountability requirements, the scope of audit, and resources allocated, including services contracted in.[149] The statement could conclude with an affirmation that internal audit is *capable* of assuring the agency's management that all accountability responsibilities imposed on the agency are addressed.

RECOMMENDATION 22

The NSW Treasury should ensure that the internal audit standards to be prepared in accordance with Recommendation 3 require the internal audit charter to include a positive statement on internal audit capabilities, indicating that all accountability issues are addressed. Where services are contracted-in, the capability statement should indicate how co-ordination of total internal audit coverage is achieved.

BROAD SCOPE OF AUDIT COVERAGE

To be effective, internal audit must have a broad scope so that it covers all areas and functions of an organisation which impact on the ability of that organisation to achieve its objectives and be accountable for its use of resources. It is the chief executive officer's responsibility to ensure that the internal audit scope does not exclude any matter relevant to the achievement of corporate objectives and the maintenance of good corporate governance.

For its internal audit inquiry, the Committee received expert evidence on the need for the scope of internal audit to cover all areas of the business from Jim Kropp—a senior audit partner from Price Waterhouse, Sydney. Mr Kropp said:

> I think that internal audit should be addressing business risks directly in setting the scope of internal audit, it should be in line directly with business exposures.[150]

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[149] Capability statements were advocated by Rory O'Connor of Deloitte Touche Tohmatsu in a paper on *Strategies to maximise the value of internal audit*, presented in the IIR conference on *Internal control and audit—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney.

[150] Minutes of Evidence, p. 182.

This view was supported by Bill Middleton—Director of the Internal Audit Bureau—who advocated the broad scope approach for internal audit in comparison with external audit in the following words:

> I think the one thing that comes out, it is the scope of the audit. There is a difference. The external auditor is looking at the financial systems and can certainly give advice on that but they tend not to be involved in looking at the other areas of that operation. . . That is a fundamental difference that needs to be made about advice. The internal auditor is looking at the whole organisation.[151]

Legislative provision

The legislative provision or mandate for internal audit is given by s. 11(2)(a) and (b) of the Public Finance and Audit Act. This requires internal audit to review the adequacy of and compliance with internal controls, and to review compliance with plans.

The Committee feels that such legislative provision for the scope of internal audit is far too general.

Comparison of standards

Both AARF (representing the professional accounting bodies) and the IIA have produced standards on the scope of internal audit activities. Table 1 compares the ways these two professional bodies view internal audit scope in their standards. They are very similar, with the AARF emphasising accounting aspects, and the IIA advocating a somewhat broader scope.

Private vs public sector

The Committee found it instructive to compare the overall scope of internal audit in the public sector with the scope of internal audit in the private sector.

A study undertaken by the Public Sector Research Centre at the University of New South Wales found that auditing in the public sector has evolved from simply providing an independent and professional assurance that public resources have been managed in accordance with the law, and that no fraud had taken place.

Public sector audit now includes forming opinions on a range of management matters, including value-for-money, efficiency, or performance audits. However, it was noted that traditional financial compliance auditing still dominates public sector audit.[152]

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[151] ibid., p. 124.

[152] L. English & J. Guthrie, 1990: *Public Sector Auditing: Private Sector Challenges to Control and Direction*, Discussion Paper No. 11, Public Sector Research Centre, University of New South Wales.

TABLE 1

COMPARISON OF SCOPE OF INTERNAL AUDIT ACCORDING TO THE PROFESSIONAL BODIES

AARF	IIA
INTERNAL CONTROLS	
Review of the accounting system and related internal controls Examination of the management control system, including the basis of management's planning and formulation of budgetary policy	Examination and evaluation of the adequacy and effectiveness of the organisation's system of internal control and the quality of performance in carrying out assigned responsibilities
INTEGRITY OF INFORMATION	
Examination of financial and operating information, including financial and non-financial information contained in the entity's financial statements	Review of the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report such information
COMPLIANCE	
Examination of whether or not the entity has complied with relevant legislation and authoritative directive	Review of the systems established to ensure compliance with those policies, plans, procedures, laws, and regulations which could have a significant impact on operations and reports, and should determine whether the organisation is in compliance
EFFICIENCY AND EFFECTIVENESS	
Examination of the economy, efficiency and effectiveness of operations, including non-financial controls of an entity	Review of operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned Appraisal of the economy and efficiency with which resources are employed
SAFEGUARDING OF ASSETS	
	Review of the means of safeguarding assets and, as appropriate, verification of the existence of such assets

Source: AARF—Statement on Applicability of Statement of Auditing Standards and Statements of Auditing Practice to Internal Auditing, ED29, issued August 1989, p. 5.
IIA—Codification of Standards for the Professional Practice of Internal Auditing, The Institute of Internal Auditors, Altamonte Springs, Florida, pp. 27-34.

One of the authors of this study—Linda English—described the differences in public and private sector auditing to the Committee:

> I would argue that the private sector audit is much narrower in scope than a public sector audit. In fact, arguably the private sector should move more towards a public sector style audit because it is too narrow.[153]

The Committee heard specific evidence from the Department of Community Services on a broad-scope approach to internal audit. The Department advised the Committee that in delivering welfare services to client services it is sometimes necessary to depart from established policy if an "out-of-policy" payment achieves the objective at a lower cost. An example of this would be a direct cash payment to support a family as an alternative to placement in an institution where the direct cash payment was considered a cheaper option than institutional care. David Marchant, Deputy Director-General of the Department, explained:

> That is a more lateral way of dealing with a client problem than we have done historically over the past decade. That requires a different method of expending money. You would expect an auditor to check the purpose, the clarity and the method of accounting. . . . They must also point out whether the method achieved the results they were after. If they were using more traditional audit processes we would get the response that they have not followed the processes because they provided out-of-policy payments on that occasion. But the out-of-policy payment achieves the objective at a lower cost. That is the sort of response we want from audit these days, not just the process response.[154]

The Committee concludes that this approach to internal audit is desirable, consistent with the concept of modern internal auditing placing increased emphasis on *what* was achieved rather than *how* it was achieved,[155] and in compliance with the Public Finance and Audit Act.

Traditionally, public sector audits have focused on financial accountability: the control and stewardship of public funds.This narrow focus yields information on how money is spent, but this is insufficient to satisfy the demands of Parliament. Ministers and their senior public servants need assurance that money spent resulted in desired program outcomes, as Parliament is increasing its scrutiny of public accountability.

In a study undertaken in the United States, the State Auditor (that is, Auditor-General) of Texas found that in addition to the traditional auditors' roles in evaluating financial information and controls and ensuring compliance with legal and regulatory matters, the scope of audit needs to be expanded to cover the following:

- Which programs provide the most for the money (economy).
- Which programs work well (efficiency).
- Who really gets the services (effectiveness).
- Which programs actually produce (program results).

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153 Minutes of Evidence, p. 192.

154 ibid., p. 98.

155 S13, p. 4.

- Which programs can be reduced or eliminated (inefficient or ineffective).[156]

In his submission, Allan Waldon—an audit manager for a large New South Wales government agency—explained how internal audit functions could be integrated to provide a total internal audit service to management covering:

- information technology audit
- compliance audit
- management audit
- corruption investigations
- corruption prevention[157]

This is the type of audit coverage the Committee expects to see in large and complex agencies.

What happens when audit scope is restricted?

In recent years, inquiries probing corporate crashes and collapses have frequently referred to the inadequacy of audit performance and, at times, glaring gaps in the scope of audit. The background to three of these cases is given on page 6.

AWA

In the AWA case—an instructive private sector example—the auditors were sued for damages after losses on foreign exchange transactions were not detected even though internal and external audit processes took place at the company. In the interim judgement it was found that management had been negligent due to a reduced scope of internal audit, particularly in the failure of internal audit to carry out an adequate review of the foreign exchange operation.[158]

In further considering the responsibilities of chief executives and the scope of internal audit or other internal mechanisms, it was held that management was responsible for establishing information and control structures which in the terminology used in this inquiry would include the scope of internal audit. The judgement said, in part, that the:

> . . . Chief Executive had an obligation to ensure that adequate internal machinery and supervision was in place, a duty he failed to discharge adequately, . . .[159]

Victorian public sector

Two separate inquiries in Victoria have reported on instances where the scope of internal audit was unclear.

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[156] L. F. Alwin, 1992: *Re-inventing the Governmental Auditor*, Internal Auditor, February 1992, p. 17.

[157] S2, pp. 2–3.

[158] Rogers J.: AWA Ltd v. G. R. Daniels trading as Deloitte Haskins & Sells & Others, Interim Judgement, 3 July 1992, p. 220.

[159] Rogers J., 1992: p. 1657 in AWA Ltd v. Daniels trading as Deloitte Haskins & Sells & others (No. 2), *(1992) 10 Australian Company Law Cases 1643.*

The Victorian Economic Development Corporation—a Victorian government statutory authority—had internal audit services provided under contract by a large international firm of chartered accountants. The inquiry into the Corporation concluded:

> . . . it was within Arthur Young's [the contract internal auditors] terms of appointment at a minimum to review the major risk areas of the VEDC's operations. I believe the objectives of the internal audit should have included, inter alia, a review of all major risk areas of the VEDC's activities, . . .[160]

These comments were accepted by the Victorian Government, and a statement by then Victorian Treasurer said:

> Internal audit is seen by the Government as a key management control which operates principally by keeping management informed regarding the adequacy of all other controls and systems. It is not a responsibility which can be transferred to an audit firm.[161]

The Tricontinental group of companies were subsidiaries of the State Bank of Victoria. Following large losses incurred by the group, a Royal Commission inquiry into the group included a review of the internal audit arrangements. Evidence had been accepted by the Commission that the scope of internal audit had been restricted. The Commission found:

> . . . in the areas which he closely controlled—especially lending and investment banking—the auditors were asked to do very little.[162]

The Royal Commission found that when the internal audit staff ventured into areas previously detailed as outside their scope of audit, the Managing Director showed a concern that there should be "no breath of criticism in areas of his direct responsibility". The Commission found:

> When Johns discovered the questions she [the internal auditor] had been asking, he confronted her rudely and made it quite clear that, if she produced a report along the lines she was contemplating, it would be torn up or returned and no fees would be paid. The auditors accepted that, so far as the internal audit was concerned, it was the managing director's prerogative to determine the scope of the audit.
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> Johns' attitude to the internal audit process was further illustrated by his failure to provide or seek any formal statement of the role of the auditors.[163]

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160 F. Ryan, 1989: *Report of Inquiry, Victorian Economic Development Corporation*, Victorian Legislative Assembly, Melbourne , p. 57.

161 The Hon. R. A. Jolly, MP, Treasurer of Victoria, 1988: *Ministerial Statement on Report of Inquiry, Victorian Economic Development Corporation*, 21 December 1988.

162 A. E. Woodward & D. G. Williamson, 1992: *Final Report of the Royal Commission into the Tricontinental Group of Companies*, 31 August, 1982, Vol. 1, p. 306.

163 ibid., p. 307.

NSW Department of Water Resources

The Department came under the notice of the Public Accounts Committee when its annual report for 1992 was tabled in the Legislative Assembly lacking an auditor's opinion on the financial statements. The report as tabled included six pages headed "Auditor-General's Opinion" but otherwise blank. This does not comply with the annual reporting legislation, which requires audited financial statements to be included in the annual report tabled in Parliament within five months of the end of the financial year.

The Committee was amazed at this breakdown in a most basic demonstration of accountability by the failure to present audit opinions to back up the financial statements. This was, to the Committee, indicative of a possible internal control problem in the Department. In evidence before the Committee, representatives of the Department were surprised at the Public Account Committee's line of questions and in response said:

> **Ms Kemp:** I think it is possibly fair to say that we did not believe there would be the emphasis on the annual report as opposed to the internal audit issues.
> **Chairman:** Is this not an internal audit issue?
> **Ms Kemp:** Yes, it is.
> **Chairman:** I think it is a key internal audit issue, is it not? . . .Would it be fair to say that the annual report to Parliament is the most important document that is produced, in terms of the accountability of the department to Parliament? Is there another one that is more important?
> **Ms Kemp:** I do not believe so
> **Chairman:** That being the case, is not this problem with it a proper matter for internal audit, and a matter for us to be looking at?
> **Ms Kemp:** Yes. Certainly.[164]

To further pursue the Committee's concerns at this matter the Committee heard evidence from Bob Scullion—Assistant Secretary of the NSW Treasury—who has functional responsibility for accounting policy and compliance with annual reporting matters. After Mr Scullion examined the copy of the Department's annual report as tabled in the Parliament, the following exchange occurred:

> **Chairman:** Does the fact that that page and other pages that should have those opinions on them are blank suggest that there is an internal control problem within the organisation? The omission suggests there is something not right in the checking process within the department.
> **Mr Scullion:** There is something wrong in their system for preparing financial reports, whether it is internal control or whether it is some degree of incompetence in preparing their statements, I cannot really identify it.[165]

When he was questioned on this matter by the Committee, the Auditor-General said:

> I agree that it does not comply, within my knowledge of the legislation.[166]

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[164] Minutes of Evidence, pp. 31-32.

[165] ibid., p. 129.

[166] ibid., p. 36.

The Committee was further concerned about internal control issues at the Department when the Auditor-General's Office gave further evidence:

> . . . the audit has not yet been completed and we are not expecting completion for about another two weeks.[167]

An internal audit perspective on this case was given by representatives of the IIA—A who advised the Committee:

> Those accounts are unaudited. You do not know whether those figures are right or wrong until the Auditor-General's certificate is supplied.[168]

The Committee received an assurance from the Department that this instance was an oversight at a time when the Department was busy with the implementation of accrual accounting. The Department advised the Committee that the bulk of the Department's financial and compliance audit services are provided under contract from Ernst & Young.[169]

The Committee has concluded above (page 81) that an audit charter should include plans for the co-ordination of audit coverage between in-house staff resources allocated to internal audit and for contracted-in audit services from private sector firms. The Committee was concerned that management in any Department—not necessarily Water Resources—might hold the view that the obligation to establish internal audit could be fully discharged merely by contracting out the function. The Committee questioned the Department of Water Resources in the following words:

> **Chairman:** I am wondering to what extent the fact that the internal audit function is essentially in the hands of someone outside your department may in fact lead to a lack of follow-through of the sorts of things we have been talking about. Is there any one officer or group of officers in the department who have a specific and on-going responsibility for the internal audit function within the department?
> **Ms Eberhardt:** Yes. What I said actually was that the financial and compliance auditing part of the internal audit program is contracted out to Ernst and Young. They review compliance with the controls that are put in place to make sure that the accounting and financial reporting is of adequate quality. There is another component of internal audit which is concerned with general efficiency and effectiveness of the programs that the department undertakes, and that is done by internal staff.[170]

It is difficult for the Committee to conclude from this other than the Department of Water Resources' internal auditors were insufficiently involved in the process of ensuring that the financial statements were audited and reported to Parliament in compliance with the normal accountability requirements in the New South Wales public sector. In this case, it appears that the internal audit scope was effectively restricted by using contracted internal

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[167] ibid., p. 36.

[168] ibid., p. 5.

[169] ibid., p. 32.

[170] ibid., p. 32.

audit services, and not fully specifying the scope of audit in the audit contract and internal audit charter.

To further pursue the scope of audit generally in the Department, the Committee heard frank evidence from the Director-General on how the challenge to provide a broad scope of internal audit coverage had been addressed as the Department underwent major structural changes together with a reduction in total staff numbers.

> **Mr Millington:** Prior to us going to contract there was a concern to me that we were not able to put enough resources into both compliance and auditing and management auditing and we tried a whole different range of approaches over the last five years. I was never content that we were actually able to provide the right input.[171]

NSW Department of Health

Internal control and audit coverage within the health sector came to the notice of the Committee as a result of some contradictory reports on the scope of audit and the commitment to internal control at various levels in the Department of Health.

In the 1992-93 State Budget, the health sector was allocated $4.03 billion, and it employed some 72,000 full time staff. The administrative structure of the Department is unique among government agencies in New South Wales.

Evidence was given to the Committee[172] that as a result of internal audit identifying instances of corruption, a study of cash handling in public hospitals was undertaken by the Independent Commission Against Corruption. The investigation identified 86 counts of larceny amounting to $110,000 and 110 counts of misappropriation amounting to $23,500[173] (see also page 32).

The Committee acknowledges that this is a good example of effective use of internal audit. However, the magnitude of the corruption that was eventually exposed by the ICAC is insignificant when compared with serious accounting and budget control problems at the Central Sydney Area Health Service, brought to the Committee's attention in the Department of Health's annual report for 1991-92:

> **Central Sydney**—failed to properly implement a new accounting system and develop sound internal controls to ensure strategies were emplace to operate within budget for the current year, including the repayment of 1990/91 loans. A report on the Area is being prepared. As at 30 June, 1992, it has operational loans of $7 million with the Department.[174]

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171 ibid., p. 159.

172 ibid., p. 93.

173 Independent Commission Against Corruption, 1993: *Corruption Prevention Project—Department of Health—Cash Handling in Public Hospitals*, p. 1.

174 op. cit., p. 50.

Surprisingly, the annual report of the Central Sydney Area Health Service for the same year referred only on page 6 to "continuous difficulty with the financial information system", and progress made on "overhaul of the financial information systems at RPAH [Royal Prince Alfred Hospital]".

The Committee pursued this matter with the Department of Health in *in camera* hearings, and was subsequently given approval from the Director-General to publicly release the following extracts from the evidence.

Evidence was given to the Committee that when new accounting systems were being installed, accrual accounting procedures implemented, and major structural changes proposed, the board of the Central Sydney AHS failed to maintain control over the AHS's finances. The Director-General told the Committee:

> They had their accrual accounting mixed up with their cash accounting and indeed their financial position was something like $6 million or $7 million over. They could not really control their clinical managers. . . Despite requests to control the numbers of resident staff and visiting medical staff and staff specialists, it was apparent that they were appointing vast numbers of additional medical staff. We could not see where the money was coming from.[175]

The Executive Director of Finance and Administration admitted that the Central Sydney AHS:

> . . . really did not monitor their new accounting system in line with our [the Department of Health's] requirements, which is a straight lift from the Treasury requirements concerning the introduction of new computer-based accounting systems.[176]

The Committee was advised that discussions between the Department and the local managers took place in an attempt to achieve budget targets. The Executive Director of Finance and Administration said:

> We found that they did not have a good internal reporting system in place. They did not have a system where the line hospital managers had to report to them, as we had them reporting to us, quantifying their reasons for variations. They did not have a high level of expertise in their finance branch and their finance branch had been virtually whittled away to nothing, and the person who was supposed to be running it had been sidetracked. They had brought in a consultant and they just were not on top of their financial management issues.[177]

The Committee was concerned that this basic failure of accountability should go undetected for a period in excess of a year.

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[175] Minutes of Evidence (in camera), p. 2.

[176] ibid., p. 3.

[177] ibid., p. 4.

The reporting of actual expenditure against budgets for the public hospital system was the subject of the Public Accounts Committee's first ever reference from a minister, as far back as 1982. The Committee made a number of recommendations including:

> Hospitals be clearly informed that it is their responsibility to set aside reserves to meet contingencies

and

> Hospital budgets be built up and monitored on a departmental basis.[178]

The Committee, in 1993, was concerned when the Department of Health advised that:

> The system proved to be a failure and they could not produce either accrual accounting results or cash accounting results. . . The results that they were reporting to the department against a cash budget were just estimates and there was nothing in them to suggest to the department that there was anything wrong substantially. . . although from time to time their financial position was challenged by the department's finance branch.[179]

The Committee pursued the matter with the Department and was told:

> The crux of the problem was that the new system was dominated by the director of finance,
> . . . he sent a survey report back to the department on the implementation of accrual accounting, which was absolutely false and told the department they were experiencing no problems, just a few teething problems. . . They have an internal audit unit. The internal audit unit did not get involved in the development and implementation of this new system, which was a major shortcoming on their part. . . The primary reason why the internal audit manager did not get involved or get his people involved was that the situation was so dominated by the director of finance that he was excluded from the operation. I believe that to be the principal factor; it came down to personalities. He did not run up the red flags or send some signals that were appropriate to the board and the audit committee through the chief executive.[180]

This is a classic case of failure in internal control resulting from internal audit being restricted in its scope, and it is valuable to analyse this issue a little further.

As will be addressed in a later section of this report (page 115), internal audit can only be effective if it is given a high degree of importance in the organisation. The organisation chart on page 3 of the Central Sydney AHS's annual report for 1991-92, reproduced here as figure 1, shows internal audit at the far end of a chain of command leading to the chief executive officer, with no apparent link with the board of directors. Even though the chart is obviously diagrammatical, and it is difficult for the Committee to believe that the

[178] Public Accounts Committee, 1982: *Over-expenditure in Public Hospitals*, Report No. 2, p. 16.

[179] Minutes of Evidence (in camera), p. 5.

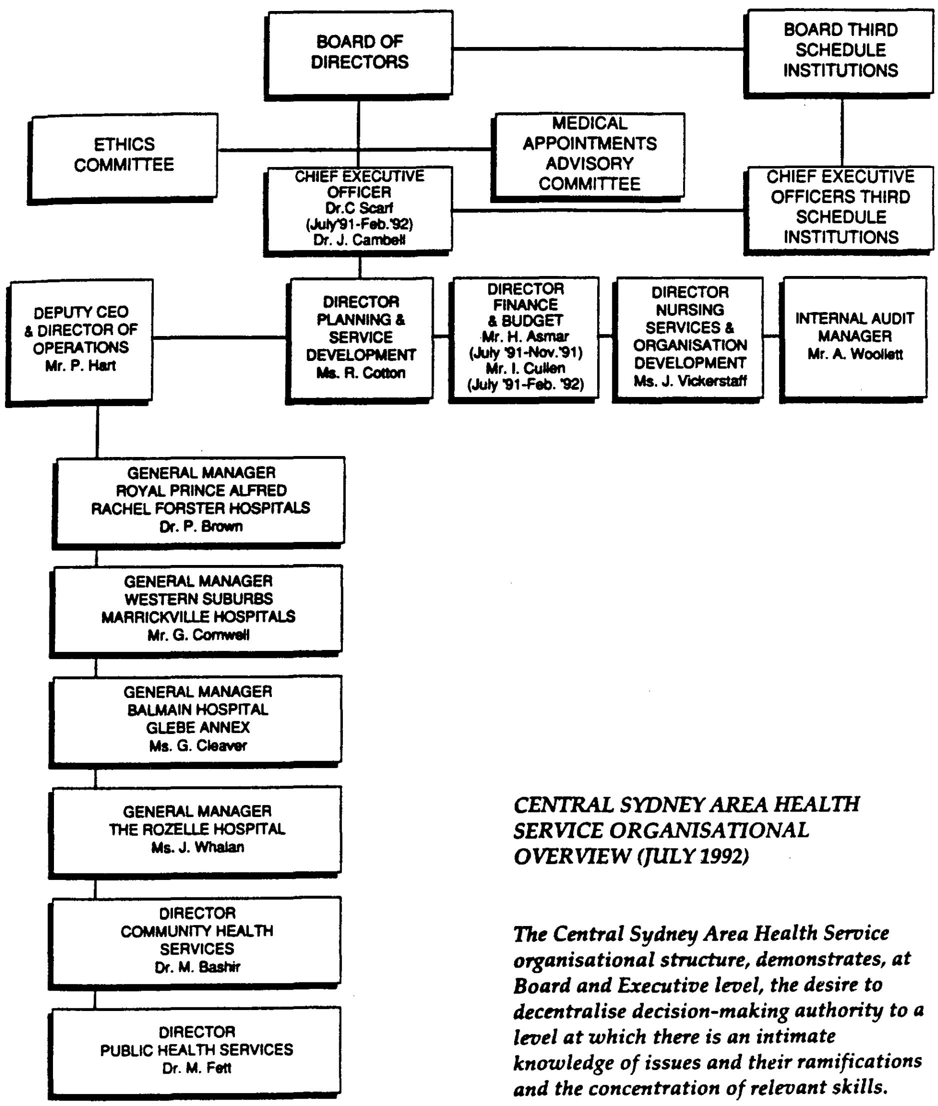
[180] ibid., p. 5.

Internal Audit Manager really reports through the Director of Nursing Services and Organisation Development, the Director of Finance and Budget, and the Director of Planning and Service Development, the chart certainly gives the impression that internal audit lies remote from the chief executive officer and the board. The reporting relationship between internal audit and management of the agency needs to be made much clearer.

FIGURE 1

ORGANISATION CHART OF THE CENTRAL SYDNEY AREA HEALTH SERVICE

(page 3 of the annual report for 1991-92)



CENTRAL SYDNEY AREA HEALTH SERVICE ORGANISATIONAL OVERVIEW (JULY 1992)

The Central Sydney Area Health Service organisational structure, demonstrates, at Board and Executive level, the desire to decentralise decision-making authority to a level at which there is an intimate knowledge of issues and their ramifications and the concentration of relevant skills.

Despite the attention given to internal audit in general and the Central Sydney AHS in particular by the Committee during hearings, the frank admissions made by departmental officials, and the fact that the AHS's annual report was not available until well after the hearings, the annual report has no mention of internal audit apart from its depiction on the organisation chart. This is another matter that the Committee will address later in this report (see page xii, 115). In fact, the rather scant details in the annual report about problems with introduction of the new computerised accounting system, which presumably gave rise to heavily qualified financial statements, has already been mentioned above.

The principal cause of the problem seems to have lain with the Director of Finance, who restricted the scope of audit in a number of ways:

- by dominating personally over the Internal Audit Manager and excluding internal audit from overseeing the implementation of the new accounting system;
- by ensuring that internal audit was overburdened by other work;
- by ensuring that internal audit was not given sufficient resources to acquire information technology audit skills, either by developing skills in-house or by obtaining expertise by contracting-in.

Major information technology projects

In his reports to Parliament for 1989 and 1992, the Auditor-General commented on a computerised system for the Attorney-General's Registry of Births, Deaths and Marriages:

> Those reports referred to shortcomings in the specification and evaluation process and noted that consideration was being given to the adoption of an alternative system, notwithstanding the sunk cost of the project which, at September 1992, stood at $14m.[181]

Funding for the computerisation project was eventually withdrawn and an interim computer system installed. Meanwhile, the Office of Public Management undertook a value for money review of 12 major information technology projects and found five that had been managed less than satisfactorily. The Auditor-General reported that the Government had since taken remedial action to ensure that agencies introducing new large computer systems conform with the Office of Public Management's Statements of Best Practice (see page 30).

The Roads and Traffic Authority experienced considerable delays in commissioning a new computer system for driver licence and vehicle registration administration—DRIVES. Although the Committee was satisfied with evidence from the Authority that internal audit had been involved in the development of DRIVES[182], the IIA-A provided advice on the role of internal audit in such computer developments:

[181] *New South Wales Auditor-General's Report for 1992*, Volume 3, p. 29.

[182] Minutes of Evidence, p. 81.

> The internal audit has such a role, and one of the good things about being in-house in the internal audit function is that you can be aware of developments about to happen. It is absolutely critical for internal audit to be involved. We call it, in the internal jargon of the audit world, being involved in a systems development methodology. Internal audit has a key role in that, and it is imperative that the internal audit have close contact with what is going on in the organisation, so that they can be involved on a pro-active basis and make sure that the controls in those systems are adequate. Internal control is not something that a lot of line people like to deal with; they get caught up to some degree in a sort of technological wave and they race ahead on that wave, and when it comes to going live with the system it often fails, whereas a good professional proficient auditor would have been able to identify some of those risks involved.[183]

The Central Sydney Area Health Service and the Registry of Births, Deaths and Marriages are examples where, in hindsight, better internal controls over development and implementation of new computer systems may have saved considerable expenditure.

Graham, Sykes and Taylor and Deloitte Ross Tohmatsu noted a general lack of commitment by internal audit and management to effective auditing of computerised information systems prior to implementation in the New South Wales public sector.[184] The Committee has to agree that internal audit involvement from the earliest opportunity in development of new systems is essential. The latter submission also suggested that internal audit should sign off critical stages of development, use risk assessment techniques to determine which systems receive internal audit attention, and use the Office of Public Management's Statements of Best Practice as a benchmark for the audit of systems under development.

The Committee feels that this is one particular area of internal auditing that needs strengthening in the New South Wales public sector, and one way this can be done is through specific reference in standards.

Conclusion

All of the evidence collected by the Committee provided overwhelming support for a broad scope of internal audit. In fact, no evidence supported any restriction on the scope of internal audit.

The Committee has inevitably arrived at the conclusion that internal audit in the public sector *has* to have a broad scope—broader in general than in the private sector. Furthermore, the chief executive officer or any other line manager of an agency should not attempt to restrict the scope of internal audit in any way. Internal audit should be given a free rein to examine any area that, in the professional opinion of the audit manager, warrants attention.

The Committee feels that s. 11(2)(a) and (b) of the Public Finance and Audit Act are too vague to be of much use in defining internal audit scope. The Committee believes that the

[183] ibid., p. 7.

[184] S13, p. 4; S11, p. 11.

expectation of a broad scope of internal audit in the public sector could be better set out in the standards the Committee has recommended the NSW Treasury to develop.

However, chief executive officers are reminded that it is *their* ultimate responsibility to ensure that internal audit has this free rein. The Committee regards any evidence that management has limited the scope of internal audit, in any way, for any reason, should be regarded as evidence of non-compliance with the legal requirement for a chief executive officer to establish an effective internal control system for the agency.

RECOMMENDATION 23

The internal audit standards to be developed by the NSW Treasury should include reference to the broad scope of internal audit that is appropriate to the public sector, including:

- information technology audits,
- efficiency and effectiveness audits,
- compliance audits, and
- control and prevention of fraud and corruption.

The need for internal audit to be involved with new information technology developments from early stages should be particularly emphasised.

RECOMMENDATION 24

Internal audit should be given a free rein to examine any area that, in the professional opinion of the audit manager, warrants attention. Any evidence that comes to light on management limiting the scope of internal audit appropriate for that agency should be regarded as evidence of non-compliance with the legal requirement for a chief executive officer to establish an effective system of internal control.

PROVIDING RESOURCES FOR INTERNAL AUDIT

Following from management's responsibility to establish a charter for internal audit with a broad scope, it is management's responsibility to ensure that the internal audit function is adequately resourced.

In seeking advice on this issue, the Committee was told by a representative of The Institute of Chartered Accountants that:

> Probably the size of the internal audit team is directly related to the size of the organisation being audited.[185]

[185] Minutes of Evidence, p. 16.

A representative of the Australian Society of CPAs followed up with:

> In terms of the Public Finance and Audit Act and the Treasury guidelines, the CEO has a clear responsibility to resource internal audit properly.[186]

Internal audit needs to be resourced so that it can carry out its audit plan in terms of the charter.

Effect of unscheduled work

The Committee was made aware of a rather common resourcing problem, initially through a routine review of annual reports. In its annual report for 1991-92, the Totalizator Agency Board provided a refreshingly frank comment on internal audit:

> The 1991-92 year was characterised by the impact that unprogrammed work had on the output of Audit and Review staff. . . Nevertheless, major investigations and reviews that were considered to have a high priority were allocated the necessary resources.[187]

The view that the ability to follow an effective audit program may be negatively affected by the requirement to conduct unscheduled work without being given additional resources was aired on numerous occasions during the course of this inquiry (e.g. S1, p. 2).

The Auditor-General offered this advice on postponing audit plans to focus on more current, higher priority issues:

> I suppose a manager can say "I will take a risk. This thing over here is burning and urgent, and I have these controls and they have been around for a few years. I will take a risk that I can delay the inspection for a year." That approach, I suppose, is reasonably tolerable. If they keep on being delayed by a year it becomes intolerable.[188]

This comes back to responsibility ultimately lying with the chief executive officer. If the chief executive officer does not provide sufficient resources for internal audit to carry out its audit plan, regardless of any additional audits that may be required, he/she runs the risk of not being made aware of problems in the organisation. If problems *do* occur in areas that were overlooked because of insufficient resources, the chief executive officer puts himself/herself in a very vulnerable position, liable to allegations of management incompetence.

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[186] ibid., p. 16.

[187] Totalizator Agency Board, 1992: *Annual Report for 1991-92*, p. 25.

[188] Minutes of Evidence, p. 45.

Staff numbers

The resources that are required by internal audit comprise funds to employ the appropriate number of appropriately skilled people. The trend to reduce staff numbers in the public sectors has not bypassed internal audit units. Certainly, it has meant an increase in the outsourcing of internal audit services to partly or fully replace in-house internal audit staff. The merits and pitfalls of outsourcing internal audit are covered above in this chapter (page 76). However, an additional factor in outsourcing is that in most cases a contract is made prior to the work being undertaken. If a chief executive officer wants to increase the workload of a contracted internal auditor, then in effect a new contract is negotiated according to market principles, and sufficient resources are automatically provided.

In-house internal auditors are at a relative disadvantage in negotiating resources and workloads because they are under the direction of their chief executive officer, and generally have no recourse to an alternative "market" to sell their services. This view has been expressed confidentially several times during the inquiry.

In-house internal auditors in the public sector are at an additional disadvantage relative to contracted internal auditors by being subject not only to budget restrictions, but also to ceilings on staff numbers. This seems to the Committee to be at odds with the concepts of program and global budgeting and accrual accounting, but this report is not the appropriate forum to pursue this thorn in the side of public sector reform.

Cuts in staff numbers within an agency can result in cuts in certain areas perceived to be of relatively low priority, or capable of absorbing increased workloads. Unless the cuts are accompanied by a commensurate cut in expected quantum and/or quality of output, or result from a professional review that identifies scope for increased efficiency, then they must be regarded as unreasonable, unjustified, and an outcome of poor management. In many agencies, salaries make up the largest component of a program's budget. Staff cuts of the type just outlined could result in the perverse situation of an agency having a program of work and a sufficient budget to achieve its targets, but being unable to spend its salaries budget according to plan simply because of inability to employ sufficient staff.

Although the Committee did not collect any specific non-confidential evidence that this practice has resulted in limiting the resources of in-house internal audit, the Committee is concerned that this is a perception among internal auditors spoken to during the inquiry, simply because the alternative of further limiting the resources for operational parts of an agency has a more direct effect on the ability to fulfil executive performance agreements.

Support for broad based skills

The Public Accounts Committee seminar on internal control and audit held last year addressed the need for an adequately resourced internal audit unit to have access to the required skills necessary to complete allocated tasks in accordance with the internal audit charter.

Commissioner Temby, speaking with the experience gained from ICAC investigations, said:

> . . . you only get what you pay for; resources must be adequate. Accordingly recruitment to the internal audit section must be open and competitive, with the aim of establishing a professional multi-disciplined unit, and internal audit must not be used as a refuge for displaced or non-performing staff. I am sure many of us have seen precisely that happen. It must be avoided above all, because when that happens then all faith in the internal audit section is lost.[189]

This view was supported by the Auditor-General—Tony Harris—who said at the seminar:

> You do need it to be adequately resourced, and you do need it adequately skilled. You need to allow it scope to examine whatever it wants in a directed way. As Jim Kropp said, when internal audit stubs its toe, it should have a right to look at the rock.[190]

The Committee agrees wholeheartedly that to be effective, sufficient resources must be allocated to internal audit so that it can acquire staff with the appropriate levels of skill.

Support for continuing education and training

The need for internal audit professionals to continue their education and training is dealt with in chapter 7 of this report under the responsibilities of the internal audit itself. This is because internal auditors are responsible for their own continuing education and training. However, management should be aware of this requirement, and strong support should be given to encourage internal audit staff to undertake relevant courses and attend relevant professional seminars and conferences. Internal audit requires special training that is not normally available within an agency. That is, training for internal audit, relative to many other areas of work, is generally skewed towards outside courses.

Specific support may include:

- leave to attend courses, examinations, seminars, conferences and professional meetings;
- payment and/or reimbursement of course fees and other course costs as well as membership of professional bodies, books and subscriptions to professional journals;
- study leave;
- co-operation with work based assignments;
- approval to use agency facilities for assignment research and reporting;
- opportunities for staff to act in higher positions in the internal audit unit.

The Committee's survey of agencies' internal audit found a generally supportive attitude to ongoing training and education. However, one agency appeared to provide no support, resulting in a senior auditor pursuing a very relevant higher degree entirely without support after having an application for support refused. Although the Committee did not hear both sides of the story, it is apparent that the professionalism of audit staff is not always appreciated by agency management.

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189 Public Accounts Committee, 1993: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, p. 16.

190 ibid., p. 76.

In recognition of the need for continuing education and training of internal audit staff, especially in view of the broadening scope of internal audit, the Committee would expect to find agencies with in-house internal audit units to be given an explicit budget for training and education, with the full responsibility for its expenditure to be given to the manager of internal audit, and not a director of corporate services, or a manager of the agency's training branch. Any other type of arrangement would work against the independence of the internal audit function.

This last point is most important. The Committee understands that some agencies have training branches or training committees which provide funds and advice on training and approve applications for training. Although there might be merit in such facilities for non-professional areas of work, the Committee believes that professional staff, who are largely responsible for their own ongoing training and education, should be also given the authority to undertake that training and education. The main role of a training committee should be to approve the training budget within the agency according to the corporate training policy, and the training branch should provide administrative support, not the final approval of an application.

It would also be expected that allowance should be made for in-house training courses on an agency's administrative and management systems, supervision, induction courses for new staff, courses on new financial management and audit software, and other internal training functions that would apply to most areas of an agency.

RECOMMENDATION 25

Internal auditors need to continue their professional education and training on-the-job, and resources have to be made available to enable this. The NSW Treasury should amend its guidelines on internal audit to require a chief executive officer who decides to have an in-house internal audit unit to provide an explicit budget for ongoing training and education of audit staff, in line with professional requirements for internal audit. Total responsibility for the administration of that budget should be given to the manager of internal audit, and the budget should be varied only with the approval of the chief executive officer.

Staff grading

Setting the right grades of staff in internal audit is a more difficult issue to assess. The Committee was fortunate to hear Michael Harris of Ernst & Young speak on this at the IIR conference on internal audit. Based on figures that he presented in his paper,[191]

[191] M. Harris, 1993: Critical recruitment and training issues impacting effective internal control and audit. Paper in proceedings of IIR conference on *Internal control and audit—improving government accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney, p. 5.

resulting from research in 1990, current salary rates for internal auditors in the private sector in Sydney would be:

Internal auditor	
1-3 years experience	$30,000-$40,000
3-5 years experience	$42,000-$55,000
Manager	$52,000-$75,000 plus benefits

Note: Add 10% for equivalent information technology auditors.

Also according to Harris, present Commonwealth public sector rates for internal auditors are in the range of:

Internal auditor	
1-3 years experience	$30,000-$42,000
3-5 years experience	$42,000-$47,000
Manager	$48,000-$69,000 plus $3,000-$10,000 performance pay

Overall this shows that salaries in the private sector and the Commonwealth public sector are fairly similar. Commonwealth public sector salaries might lag in the senior management levels, but this could be offset by other remuneration benefits.

The Committee's survey of internal audit in the New South Wales public sector included information on salaries of internal audit managers and staff. Maximum salaries and salary ranges within internal audit units both tend to increase with size of the units, which in turn reflects the size of the agencies in terms of any or all of revenue, expenses and staff numbers.

The following ranges were found:

Internal auditor	$33,500-$58,100 (equivalent to Administrative & Clerical Grade 5 to Grade 12)
Manager	$38,100-$100,000 plus other non-salary benefits (equivalent to Administrative & Clerical Grade 7 to SES Level 2)

It is difficult to make meaningful comparisons using such broad ranges, but overall it appears that the New South Wales public sector salaries compare favourably with those in the private sector and the Commonwealth public sector.

In large agencies such as Department of Health, Pacific Power, Roads and Traffic Authority, Department of School Education, State Rail Authority, Sydney Electricity, TAB, Water Board and the Department of Water Resources, the manager of internal audit is employed under the terms of the Senior Executive Service Levels 1 or 2. Internal audit managers at Administrative & Clerical Grade 7-8, Grade 8, and Grade 9-10 were found in the three smallest agencies surveyed.

Some internal auditors spoken to in the survey conveyed a perception that budget sector agencies pay lower salaries to internal auditors than non-budget sector agencies. This is because non-budget sector statutory authorities often have greater freedom in their staffing arrangements. Unfortunately the Committee's survey was insufficiently rigorous to be able to either support or refute this contention. The Committee expects that salaries for internal audit staff of all agencies should be determined according to salaries typical of the profession as a whole, rather than tied to grade restrictions for the public sector.

Harris' paper concludes with an astute observation:

> The solution is not just to pay people more—which is fortunate given the public sector environment. . . This is not to say that dollars are not important. Managers should monitor remunerations being paid elsewhere and stay competitive. Otherwise, they are just developing quality audit staff for someone else's benefit.[192]

Seconding staff to internal audit

The Committee heard evidence that some agencies second staff to their internal audit branches to assist in audits of the areas from which those officers came.[193] This is an economical way of enhancing the skills in internal audit, at least on a short term basis. However, the Committee sees this as risking a compromise of the audit independence, as a seconded officer may be reluctant to reveal problems in controls that are the responsibility of his/her superior officer, particularly if the officer intends to return to the original branch.

There should be no problems in an officer remaining in the branch to be audited and assisting the audit while still under the control of the branch head. In such cases it remains the responsibility of the auditor to conduct a thorough, professional and objective audit, and the officer is not put in a position where he/she has dual loyalties.

On the other hand, it would not be inappropriate for an officer from one area to be seconded to internal audit to assist with the audit of another area. In a regionalised agency this would in fact have the advantage of exposing officers, not only to the experience of internal audit, but also to the methods, skills and ideas of other regions.

192 ibid., p. 6.

193 Minutes of Evidence, p. 74.

Conclusion

In the spirit of its Report No. 15, the Committee concludes that it really is the responsibility of the chief executive officer to determine the appropriate resources that are provided to internal audit, and that it would be inappropriate for the Committee to dictate how that is achieved. The results will eventually speak for themselves.

Perhaps instead of trying to impose legal requirements and guidelines on a chief executive officer in relation to resourcing internal audit, a preferred approach would be to *encourage* chief executive officers to provide adequate resources.

A later recommendation refers to including in the annual report a section on internal audit, including any problems experienced such as those so frankly admitted by the TAB. This, as well as the current requirement for the external audit to review the adequacy of internal audit, with serious problems also having to be mentioned in an annual report, should help to reinforce the need for adequate internal audit resources.

RECOMMENDATION 26

Internal audit independence from the operations of an agency is paramount. Conflicts of interest can arise, however, in some cases in which operational staff are seconded to internal audit. The NSW Treasury should include in the internal audit guidelines a requirement for chief executive officers to not use seconded staff in internal audit to audit the areas in the agency from where they are seconded.

ASSURING QUALITY OF AUDIT

Responsibility for ensuring the quality of internal audit is shared between the chief executive officer and the manager of internal audit. The establishment of an internal audit function does not absolve the CEO of responsibility for internal control—internal audit is but a service to management. Obviously, the chief executive officer needs some independent assurance that the internal audit function is effective in ensuring that other internal controls are in place and that organisational targets are being achieved.

For the public sector, the requirements for both internal and external audit are broader and more varied than in the private sector. Because of perceived higher accountability expectations in the public sector, it could be argued that the quality of audits in that sector must also be higher. Increased devolution of authority to managers, concomitant with increased requirements for performance targets and performance monitoring of executive officers, have resulted in CEOs relying more on internal audit to be the eyes and ears of management. How then does the CEO satisfy himself/herself that internal audit is providing an adequate quality of service?

Firstly, the CEO should ensure that the manager of internal audit has in place a quality assurance program. This is explained more fully in chapter 7 of this report.

Secondly, the use of questionnaires to line management has been suggested by the ANAO as an effective means of a chief executive officer monitoring and improving audit quality.[194] Questionnaires can be issued by both the chief executive officer and the manager of internal audit. The former would be particularly interested in using questionnaires to gauge the perception of both management and staff in the audited areas concerning the degree to which the audit added value. Alternatively, where an audit committee of a management board exists, it would be appropriate for that audit committee to issue questionnaires.

RECOMMENDATION 27

Questionnaires can be useful to a chief executive officer in monitoring and improving internal audit performance. The NSW Treasury should include in the guidelines on internal audit a recommendation that the chief executive officer or the audit committee should review the quality of internal audit through questionnaires to management.

Review by the Auditor-General

For this inquiry the Committee wanted to gain an impression of the current quality of internal audit in the New South Wales public sector. The most recent comprehensive evidence was provided by a special review of the effectiveness of internal audit in 105 agencies conducted by the Auditor-General for the 1986-87 financial year and the following year to April 1988. The review was confined to the financial compliance aspect of the internal audit and was based on the Statement of Auditing Practice AUP2—*Using the Work of an Internal Auditor.*

Results of the review were rather disappointing:

> In fourteen of the 105 units reviewed, Internal Audit was generally found to be operating below acceptable levels of performance and little reliance could be placed on its work. In another twenty one of these units, although it was possible to place some reliance on Internal Audit's work, there were inadequacies in certain aspects.
>
> The review indicated that Internal Audit were not fully effective in a number of key areas of operations. While not all items were relevant to each organisation, the major items included:

[194] Australian National Audit Office, 1993: *A Practical Guide to Public Sector Internal Auditing*, pp. 21-22.

- Inadequate planning
- Inadequate review of financial systems
- No involvement in financial statement verification
- Scope of work too limited
- Staff shortages or staff engaged on special projects
- Inadequate reporting procedures
- Poor performance levels
- Unqualified, inexperienced and untrained staff.[195]

A follow-up review was conducted in 1988-89 of a small number of those internal audit units found the previous year to be operating unsatisfactorily. The follow-up indicated that

> . . . while there had been some improvement in the overall standard some units were still not fully effective in a number of key areas of operations.[196]

and

> . . . the general performance of some internal audit groups in the New South Wales public sector is below standard. Moreover, the training, qualifications, experience and approach of some internal auditors are sometimes less than I consider desirable.[197]

These comments were noted in the Public Accounts Committee's report on the Auditor-General's Office, where the current inquiry was also foreshadowed.[198]

The Auditor-General continues to comment on deficiencies in internal audit and other internal controls as part of the statutory external audit of government agencies. Comments are made in management letters, red rule reports, and reports to Parliament. In the Auditor-General's reports to Parliament, there have certainly been many comments about significant matters arising from deficiencies in internal controls. But based on a relative lack of adverse comments specifically about internal audit in Auditor-General's reports over the last couple of years, the Committee perceived that internal audit quality is generally improving.

The Auditor-General confirmed this in his initial submission,[199] and again with qualification in evidence:

> **Mr Chappell:** . . . Can you give us your overall assessment on the standard of internal audit in the public sector in New South Wales at the present time?
> **Mr Harris:** It is improving. It is improving, but I think there is a long way to go before it has the form and the substance that you might regard as acceptable.[200]

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195 *New South Wales Auditor-General's Report for 1988*, Volume 2, p. 91.

196 *New South Wales Auditor-General's Report for 1989*, Volume 2, p. 91.

197 ibid., p. 106.

198 Public Accounts Committee, 1990: *Report on the Auditor-General's Office*, Report No. 49, p. 139.

199 SO, p. 6.

200 Minutes of Evidence, p. 150.

The external audit by the Auditor-General is the final check in the system that a chief executive officer has all of the proper internal controls in place. Deficiencies revealed by the external audit must reflect on the performance of the CEO, who in turn is held accountable for that performance. The Committee can therefore not stress too much that the CEO should ensure that the internal audit function effectively keeps him/her fully informed, as this provides one of the best forms of insurance against programs going off the rails.

FOLLOWING-UP AUDIT RECOMMENDATIONS

Deloitte Ross Tohmatsu pointed out to the Committee that one of the major elements of effective internal audit is to have in place a procedure for monitoring the progress of internal audit recommendations made and clearly identifying whose responsibility it is within the agency to do this.[201] Follow-up of audit recommendations should be addressed in the internal audit charter of an agency. This document should enunciate that agency management has a responsibility to consider the internal audit report and take appropriate action to improve deficiencies identified by the audit, and that the internal audit itself has a responsibility to perform post implementation reviews and report accordingly.

In her submission and in hearings, Linda English from the University of Sydney advocated the use of audit committees as a further check that internal audit recommendations are adequately followed up by management. The Committee addresses audit committees in detail from page 121.

SHOULD INTERNAL AUDIT BE PROVIDED BY THE EXTERNAL AUDITOR?

One of the major issues that emerged from the Committee's seminar on internal audit was the question of audit independence, and particularly the independence of external auditors who also provide internal audit services. This arose from the problems of Tricontinental, whose internal and external audit were provided by the one firm of chartered accountants.

At the seminar, in answering a question on external auditors also providing internal audit services, Jim Kropp of Price Waterhouse said:

> From a practical point of view, I really fail to see how one who has an independent state of mind, whether it matters very much as to the nature of the audit work that you are providing, and I would be as a general principle quite comfortable with the idea of an external auditor providing internal services . . . and that if I am an internal auditor, my independence would in some way be compromised. I take exception to that and challenge any of you to demonstrate how my independence would be compromised by being both the internal auditor and the external auditor. However, having said that, as a matter of commercial

[201] S11, p. 5.

> practice in my own firm we are moving very rapidly to the situation where separate partners are responsible for internal audit on external auditor clients.[202]

Tony Harris—the New South Wales Auditor-General—in answer to the same question said:

> "I know the standards allow that . . . I am not particularly attracted to a situation where the same organisation undertakes the internal and external auditing.[203]

In *The Australian* shortly after the seminar, McGuiness discussed the question of auditors' independence under the headline *Corporate honesty is the best policy* and said:

> . . . even the possibility of conflict of interest is an issue of concern.[204]

Concerns over the independence of external auditors who also provide internal audit services was the subject of a study by Dr O. Zaid from the Department of Accounting and Business Law at the University of Western Sydney. Zaid concluded:

> The performance of both the external and internal audit functions for a public company by the same person or firm is incompatible. The incompatibility is based on the effect of the dual role on the criterion of independence, which is professionally and legally recognised as the prime criterion of the external audit function.
>
> It is also concluded that external auditors, in performing the internal audit function for a particular public entity, are acting in a similar capacity as employees or officers of the entity. Therefore, to maintain their integrity, objectivity and independence, they should not act as external and internal auditors for the same entity.[205]

The call for independence for both internal and external audit was supported by Ernst & Young, who said:

> To ensure the independence of internal audit, where a public sector internal audit needs are met by outside professional consultants, those consultants should not also provide other services which might be perceived to impair their independence, specially external audit (on behalf of the Auditor-General), or management consulting services.[206]

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202 Public Accounts Committee, 1993, *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, p. 80.

203 ibid., p. 79.

204 P. P. McGuiness, 1992: Corporate honesty is the best policy, *The Australian*, 1.12.92.

205 O. Zaid, 1991: External auditors independence: impact of their new role as internal auditors. *Working Paper Series No. 10*, University of Western Sydney, Macarther.

206 S5, p. 1.

Relevant standards

In determining the relevance of this debate to the Committee's own inquiry into internal audit, the Committee considered the due process involved in the issue in August 1992 of the Statement of Auditing Practice AUP32: *Audit Independence*. The due process involved in the issue of professional audit statements requires the issue of exposure drafts with a time open for discussion and comment by members of the accounting profession and interested persons. The development of AUP32 is interesting in that opinions vacillated from the first exposure draft through to the second exposure draft and to the final statement.

The first exposure draft issued in October 1990—ED37—included proposals to *restrict* external and internal audit services being provided by the same auditor:

> PROVISION OF INTERNAL AUDIT SERVICES
>
> The auditor should not (except with the parameters outlined below) undertake engagements which result in the auditor becoming part of the entity's accounting system and related system of internal control (to the extent that the scope of the audit might thereby be, or be seen to be, controlled by management). To do so would prima facie compromise the auditor's independence when considering the degree of reliance to be placed on internal controls within the entity. It is for the external auditor to clearly demonstrate independence and not to act in a manner which may cast doubt on independence. The auditor's independence would not be compromised when undertaking tasks as an external auditor normally performed by internal audit departments, when to do so is considered necessary to gather sufficient appropriate audit evidence when forming the audit opinion.[207]

There is potential for an agency to benefit from the provision of the internal audit function by the auditor responsible for the audit of the financial statements, as the extra time spent with the agency *should* result in a more effective and efficient total audit. However, the risk of a perceived loss of independence could outweigh such benefit.

In September 1991, a revised exposure draft—ED40—was issued which clearly proposed a *ban* on the external auditor also providing internal audit services. In ED40, it was suggested that the perceived lack of independence *would* outweigh the benefit to be derived by the provision of audit services by the same auditor:

> The auditor responsible for the audit of an entity's financial report should not also provide the internal audit function for that entity. The provision of such services by the external auditor could damage the perception of the independence of the auditor in the eyes of financial report users and other interested parties for the following reasons:
>
> (a) the auditor may have, or appear to have, too close an involvement with the aims and objectives of the entity;

[207] Australian Accounting Research Foundation, 1990: *Proposed Statement of Auditing Practice—Audit Independence*, ED37, p. 14.

(b) the auditor may appear to be involved in the decision-making processes of the entity, particularly in relation to systems design;

(c) the auditor may display, or appear to display, bias when assessing internal audit work and may place undue reliance upon because of the involvement of colleagues; and

(d) the auditor may be perceived to be producing and auditing the same work.[208]

The Statement of Auditing Practice AUP32 that was issued after consideration of comment on ED40 surprisingly *effectively allowed* for the provision of internal and external audit services by the same auditor, although it was acknowledged that:

> The provision of internal audit services by the external auditor of the same entity may . . . place at risk the perception of the independence of the external auditor from the perspective of financial report users and other interested parties.[209]

The statement, however, considers the principles that should be applied by external auditors if they wish to provide internal audit services to the same client:

(a) Decision Making
- (i) the external auditor should not assume the role of management when undertaking internal audit services; and
- (ii) any recommendations made by auditors are for implementation by management rather than the auditor; and

(b) Objectivity
- (i) the external auditor should not accept any internal audit engagement which involves the auditor becoming part of the entity's internal control structure relating to the preparation of financial report information; and
- (ii) the external auditor should gather sufficient appropriate audit evidence through the conduct of appropriate audit procedures when forming an opinion on the financial report and should not place any more reliance on work undertaken by colleagues than that undertaken by any other internal auditor.[210]

Nevertheless, the Committee strongly feels that auditing in the public sector differs from that in the private sector because of the much stronger need for accountability in the public sector. For instance, any one government agency is accountable to the whole population of New South Wales, and this is certainly a much larger number of stakeholders than in the largest private sector business operating in the same State.

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208 Australian Accounting Research Foundation, 1991: *Proposed Statement of Auditing Practice—Audit Independence*, ED40, p. 15.

209 Australian Accounting Research Foundation: Statement of Auditing Practice AUP 32: Audit Independence, *Australian Society of CPAs' Members' Handbook*, Volume Two, p. 3305.

210 ibid., p. 3306.

Accordingly, the Committee feels that different standards of audit independence should apply, with a much greater need for audit independence to be shown in the public sector.

Occurrences in New South Wales

In view of the Auditor-General's expressed disapproval of the practice of external audit and internal audit being provided by the same organisation, the Committee was rather surprised to receive a submission from the Internal Audit Bureau that firstly alleged that the Auditor-General was in fact engaging in such a practice, and secondly recommended that the Public Accounts Committee direct the Auditor-General to stop it.

As mentioned above on page 73, the *internal audit and related services* the Bureau is concerned about comprise:

- secondment of staff from the Audit Office to agencies to assist with development of internal audit functions and other internal controls
- provision of advice on internal audit and other internal controls resulting from the external audit
- extended or expanded external audit
- internal audit for the ICAC.

The issue of extended or expanded external audit is discussed more fully in that section, where the Committee expressed satisfaction with the Auditor-General's explanation. Consideration of the other three issues now follows.

Secondments

The Auditor-General currently seconds senior staff to the State Rail Authority and the New South Wales Aboriginal Lands Council at the request of the chief executive officers of those agencies. During the period of secondment, those officers are responsible to the agencies in which they are working, and not to the Auditor-General, but they impart their knowledge gained through their considerable experience in external auditing to their host agencies. Furthermore, while the Auditor-General has staff seconded to the internal audit of an agency, other staff of the Audit Office conduct the external audit.

Far from seeing any conflict of interest or loss of audit independence, the Committee commends this approach by the Auditor-General. However, the Committee is unsure about whether such secondments should be part of the Auditor-General's core role, and agrees with implications by the Internal Audit Bureau that they would probably be more appropriate to the role of the Bureau. Although reluctant to adjudicate on the roles of the Auditor-General and the Internal Audit Bureau, the Committee would prefer to see a greater level of co-operation between them.

Of course, the chief executive officer of an agency should have the ultimate responsibility for deciding whether to recruit permanent internal audit staff, contract internal audit services from the Internal Audit Bureau or from the private sector, or to second available staff from the Auditor-General's Office.

Audit advice

The Committee heard evidence from a number of sources that part of the Auditor-General's role is to offer advice to agencies on matters that come to the attention of auditors in the course of the audit process.

The Internal Audit Bureau, however, claimed that:

> By providing other audit related services to clients, he is providing management with advice that he will ultimately have to review and report on to Parliament. What if his advice is wrong? Will he be able to report objectively to Parliament on an issue where he has influenced the decisions of management.[211]

The Committee does not agree with this submission, as it implies that the experience and competence developed by the Auditor-General and his staff across their wide range of audit engagements should not be used to the advantage of individual agencies.

Also, IIA standards for internal auditing state that:

> Internal auditors need access to external auditors' management letters. Matters discussed in management letters assist internal auditing in planning the areas to emphasize in future internal audit work.[212]

In the context of an auditor-general giving advice to an auditee in the public sector in Australia, the Deputy Auditor-General from the Australian National Audit Office said:

> Yes, we would but we see that as one of the roles he is carrying out on behalf of the Parliament.[213]

The Committee concludes that there is no conflict of interest and no loss of audit independence associated with the Auditor-General providing any constructive advice to agencies on internal audit or other internal controls during the course of the external audit. In fact, the Committee agrees with the Auditor-General that this is an important facet of an external audit.

Internal audit of the ICAC

This is the only case in which the Auditor-General provides both the internal and external audit to the same agency. The Auditor-General explained to the Committee:

> The argument for one auditor is based on the confidentiality of information held by the Commission, and the increased risks that would occur if two agencies undertook the two audits. The Commission apparently considers that a self-conducted internal audit is not viable.

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[211] S9, p. 29.

[212] The Institute of Internal Auditors, 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, Florida, p. 52.

[213] Minutes of Evidence, p. 204.

> The Auditor-General's Office internal audit mandate provided by the Commissioner is comprehensive. This contract is thus a specific example of the potential for conflict of interest that was raised by the PAC. The Office has judged that the circumstances behind the request by the Commission justifies the cost arising from potential conflict of interest.[214]

It is relevant that the ICAC is overseen by a statutory parliamentary committee, which provides a further check on its operations. The Auditor-General and his reports are also subject to review by a statutory parliamentary committee—the Public Accounts Committee—which provides an opportunity for parliamentary scrutiny of possible conflicts of interest.

The Committee agrees with the Auditor-General that the exceptional circumstances in this case probably justify the current arrangement regarding internal and external audit. However, the Committee would be more confident if the Treasurer was required to provide the final adjudication.

Conclusion

All of the evidence appears to the Committee to show that it is inappropriate to generally allow both internal audit and external audit to be carried out for a government agency by the same auditor. The situation may be different in the private sector—that is really a matter for the Australian Securities Commission and the professional accounting bodies to decide—but the public sector demands much stronger accountability.

On the other hand, the Committee is satisfied with the Auditor-General's explanations given in response to the allegation by the Internal Audit Bureau that the Auditor-General is providing internal audit and related services to the same agencies he is auditing externally. The Committee interprets the allegation as possibly reflecting some tensions between the Auditor-General and the Internal Audit Bureau, and the Committee expects that such tensions could be eased if a greater level of co-operation between them was encouraged.

On the issue of the Auditor-General's staff signing off both the internal and external audit, the Committee acknowledges that exceptional circumstances can arise which perceivably justify this, for example, in the case of the ICAC. In such cases, which are and indeed *should* be very few, the Committee feels that the Treasurer should give the ultimate approval.

Another possible scenario that the Committee considered was that the Auditor-General could, under s. 35(1) of the Public Finance and Audit Act, contract a *firm* to conduct the external audit of an agency, and then that firm could in turn be contracted by the agency to conduct the internal audit as well. The area health services of the Department of Health, for example, are audited on the Auditor-General's behalf by contractors, and there is therefore an opportunity for those contractors to also conduct the internal audit.

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[214] S15, p. 2.

The Committee understands that the Auditor-General has a policy of not allowing such an arrangement.

Nevertheless, the Committee is concerned that policies can easily change, or they can be ignored with little or no sanctions able to be applied. The Committee was strongly swayed by Ernst & Young's submission that outside internal audit contractors should under no circumstances conduct both the internal and external audit, and the Committee recommends that the legislation should be strengthened in this regard.

RECOMMENDATION 28

The Auditor-Generally currently seconds senior staff to agencies, at their request, to assist with establishing an effective internal audit function. With the recent establishment of the Internal Audit Bureau as a statutory authority with a role of providing internal audit services to agencies, there is a need for co-operation between the Bureau and the Auditor-General in provision of internal audit services. Before providing further staff on secondment to agencies to assist with developing the internal audit function or other internal controls, the Auditor-General should raise the matter with the Director of the Internal Audit Bureau to ascertain whether a secondment, a contracted service or other arrangement through the Bureau would be more appropriate.

RECOMMENDATION 29

In the public sector, in which a greater level of accountability is required than in the private sector, it is generally inappropriate for both the internal audit and the external audit of an agency to be conducted by the same auditor. The Treasurer should amend the legislation to prevent an agency from using both external and internal audit services from either the Auditor-General or a firm contracted by the Auditor-General, other than in exceptional circumstances (such as those relevant to the ICAC). The Treasurer should be responsible for approving such exemptions.

CHAPTER 6: MANAGEMENT AND BOARD RELATIONSHIPS WITH INTERNAL AUDIT

PLACING INTERNAL AUDIT IN THE AGENCY'S STRUCTURE

Importance of internal audit

As said at the outset, the primary aim of the Public Accounts Committee's report on internal audit is to raise the profile of internal audit within government agencies.

The Committee surveyed a broad selection of annual reports to determine whether internal audit was regarded of sufficient importance to be placed on the organisation chart (where there is at least one staff officer responsible for internal audit) and/or be mentioned in the text with regard to its achievements, problems and plans. Reporting relationships between internal audit and the chief executive officer were also examined. The survey method and results are presented in appendix 3.

To gain a better appreciation of the importance that agency managers place on their internal audit units, the Committee conducted a small survey of in-house internal audit, focussing on staff size, salaries, qualifications, training, audit charter and audit committees. The 21 agencies surveyed and details of the information requested are listed in appendix 4.

The Committee has concluded from these surveys, as well as from evidence in hearings and from informal discussions, that many agency managers do not regard internal audit very highly at all. There are no doubt a multitude of reasons for this attitude. A simple lack of awareness of what service internal audit can provide seems, to the Committee, to be a very likely reason.

The Committee expects that its recommendations for improved internal control and audit guidelines for chief executive officers will go some way to redressing this lack of awareness. The remainder of this chapter looks at relationships between agency executive management, boards of management, and internal audit, where improvements should help to increase awareness of many aspects of internal audit.

Reporting relationships

The Public Finance and Audit Act clearly requires a chief executive officer to establish and maintain an internal audit function directly responsible to the chief executive officer. As outlined on page 17, this arises from a recommendation of the Audit Act Review Committee for internal audit to report directly to the executive level of management.

The Committee interprets the Act as ensuring that there is no impediment in internal audit carrying out the directions of the chief executive officer and reporting back to that officer. In other words, the internal audit should obtain resources from the chief executive officer, and report back to that officer without the need to have reports vetted by other line management officers. The intent of this is to set up the internal audit function as completely independent from the remainder of the agency.

The inquiry found many cases in which a direct reporting relationship between a chief executive officer and internal audit was not apparent, and the independence of the internal audit could be compromised. In most cases followed up by the Committee in hearings, it was said that internal audit was able to directly report to the chief executive officer, but that internal audit was administratively responsible to someone else.

Police Service

The Police Service is a good example of this, where the Manager of the Comprehensive Audit Branch is responsible to the Assistant Commissioner (Professional Responsibility) rather than to the Commissioner. In hearings, the Audit Manager explained to the Committee his access to the Commissioner:

> If the situation arises, as we have established that we do have direct access to the Commissioner at any time, I would normally inform Mr Cole [then the Assistant Commissioner (Professional Responsibility)] first and then we would make arrangements to see the Commissioner. So to date, there has not been the situation where we have not been able to see the Commissioner. Access is fairly free.[215]

Although the Audit Manager also explained that he could and would go directly to the Commissioner if the need arose, the Committee was puzzled over why a direct reporting relationship between the Manager and the Commissioner was not formalised. As mentioned on page 33, the Police Service has recently received public attention because of problems with management of complaints against police.

The Police Service's submission includes a schedule of auditable areas showing audit priorities over a three-year audit cycle.[216] The Committee understands that complaints against police are handled by two branches—Internal Affairs Branch and Professional Integrity Branch—both under the responsibility of the Assistant Commissioner (Professional Responsibility).[217] In the schedule of auditable areas, these two branches are given a low priority for internal audit with a three-yearly audit cycle, compared to a higher priority for auditing of financial matters with annual or two-yearly audit cycles.

Action has recently been taken against two assistant commissioners over failure to properly report complaints against police. One of these was the Assistant Commissioner (Professional Responsibility), who was stood aside. The Committee expects that auditing of complaints against police would now be given a much higher priority, but the Committee is surprised that there has been no apparent change in the reporting relationships in view of, firstly, the direct contravention of the Public Finance and Audit Act, and secondly, the recent control problems within the Police Service in general and with the then Assistant Commissioner (Professional Responsibility) in particular. Instead

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215 Minutes of Evidence, p. 61.

216 S12A, appendix 2.

217 Annual Report of the New South Wales Police Service for 1991-92, pp. 57-59.

of internal audit reporting to the Assistant Commissioner (Professional Responsibility), the internal audit should be a check on this position.

Other arrangements

The Committee is aware of internal audit units responsible to the manager/director of:

- "finance" (Roads and Traffic Authority, State Transit Authority),
- "administration" (Department of Sport, Recreation and Racing; State Transit Authority)
- "corporate services" (Department of Conservation and Land Management, Rental Bond Board, Tertiary and Further Education Commission, Fire Brigades, Motor Accidents Authority)
- "management" (Legal Aid Commission)
- "operations" (Department of Local Government and Co-operatives)
- "planning and review" (Department of Mineral Resources)
- "commercial services" (Commercial Services Group)
- or an assistant or deputy chief executive officer (Premier's Department, NSW Superannuation Office).

This is totally inappropriate as the internal audit could not be regarded as independent. The internal audit manager would be put in a difficult position if he/she arrived at findings critical of his/her superior officer's management, and the director of whatever would understandably be reluctant to pass on an internal audit report that was critical of the director's own area of responsibility. This sort of arrangement would very likely lead to conflicts of interest and the internal audit being compromised.

The Committee is not convinced that internal audit needs to be administratively responsible to any position in an agency other than the chief executive officer. Such an arrangement implies that the position to whom internal audit is administratively responsible is in fact responsible for providing the resources to, and possibly monitoring the use of those resources by internal audit. It is therefore easy to see how a director of whatever could influence the scope and quality of audit by restricting resources, thus increasing the chief executive officer's risk of failure of controls.

The Committee is convinced that internal audit must be professionally, administratively and clearly responsible to the chief executive officer of an agency, and to no other officer. The flip side is that the chief executive officer is seen to be responsible for internal control and audit, and that there is no opportunity for the chief executive officer to point a finger at any staff for breakdown in controls.

However, there needs to be a qualification relating to what actually constitutes internal audit. Some agencies distinguish between internal audit and "performance review", "management review", "program evaluation" etc., in which internal audit is restricted to its more historical meaning of financial audit. The manager of such internal audit might report to a director of "management review" or some other such name, where the director is in effect an internal auditor under the broad definition enunciated on page 3 of this report. As long as the director of whatever does not have any line management responsibility for *operations* in the agency, such as provision of service, accounting, budgeting, planning or other support function, then the Committee would be satisfied if that director reports directly in all ways to the chief executive officer.

Certainly, neither the internal audit manager nor internal audit staff should have any simultaneous line management responsibilities for operations that do not fall under the definition of internal audit. Furthermore, the internal audit unit should not be looked upon by senior management as a potential pool of staff to fill temporary vacancies in the agency—the Committee again stresses the importance of maintaining internal audit as an independent professional service.

Accountability for internal audit

Prof. David Fraser from the University of Technology, Sydney made a useful suggestion to the Committee in the hearings:

> It might be worthwhile—and I think this is copied in the US—to require management to report on the internal control system in an annual report.[218]

There are currently several requirements for providing information on appraisal functions in annual reports. Premier's Memorandum 91-3 (24 December 1990) requires all agencies to undertake an annual "program of evaluations", in which programs, activities or operations are systematically evaluated. It also requires results of evaluations to be included in agencies' annual reports, but this has never been given statutory backing.

Section 4(1)(h)(ib)-(ic) of the Annual Reports (Statutory Bodies) Regulation 1985 and s. 3(h)(iii)-(iv) of the Annual Reports (Departments) Regulation 1986 require agencies to include in their reports:

> the nature and extent of performance review practices and of improvements in organisational achievements as assessed by both internal and external performance reviews;

and

> benefits achieved as a result of management and strategy reviews

Finally, s. 7(1)(a)(iia) of the *Annual Reports (Statutory Bodies) Act 1984* and s. 9(1)(b1) of the *Annual Reports (Departments) Act 1985* require:

> a response from the statutory body/Department Head to any issue which the Auditor-General or an authorised person raises in a report under section 43(2)/45I(2) of the Public Finance and Audit Act 1983 as being a significant issue

This requirement for annual reports to include responses to significant issues raised in the Auditor-General's audit reports was assented to in December 1991, yet was omitted from the Treasury Circular No. G1992/15 on *Annual reporting requirements*, dated 10 July 1992. It was not surprising to the Committee, therefore, that very few agencies complied

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[218] Minutes of Evidence, p. 136.

with this requirement in their annual reports for years ending 30 June 1992 and later. The Committee foreshadows that it will be paying particular attention to this requirement in the annual reports due for the year ending 30 June 1993.

The Committee concludes that there is scope for strengthening all of these current requirements and incorporating Prof. Fraser's suggestions. What the Committee would like to see is a section on internal audit in each annual report, regardless of whether the internal audit is contracted-out, in-house or a combination.

In an annual report, a section on internal audit should include:

- the program of internal audit planned for the year under review
- internal audit functions contracted out and conducted in-house
- major findings of the audit and other significant matters relating to reviews of internal controls
- major internal audit recommendations and management's response, including reasons for not implementing recommendations
- problems experienced in conducting the planned audit, for example, impact of unscheduled work, staff turnover
- the audit plan for the following year.

There is a general feeling in the Committee that annual reports are tending to become merely "good news" stories, with limited frank disclosure about real problems encountered during the year. A requirement to report on internal audit would enable interested people, particularly Members of Parliament, to compare problems experienced by agencies and brought to light by the media with the areas examined by internal audit and the problems identified by audit and rectified. This would be a valuable accountability requirement for the chief executive officer, who would be less inclined to ignore real problems in the annual report.

RECOMMENDATION 30

Many chief executive officers have failed to ensure that their internal audit units report directly to them as required by the Public Finance and Audit Act. To ensure compliance, chief executive officers should be required to specify in their agencies' annual reports diagrammatically or in the text the appropriate internal audit reporting lines, and the Treasurer should amend the legislation accordingly.

RECOMMENDATION 31

Chief executive officers should ensure that their agencies' annual reports include a section on internal audit covering:

- the program of internal audit planned for the year under review
- internal audit functions contracted out and conducted in-house
- major findings of the audit and other significant matters relating to reviews of internal controls
- major internal audit recommendations and management's response, including reasons for not implementing recommendations
- problems experienced in conducting the planned audit, for example, impact of unscheduled work, staff turnover
- the audit plan for the following year
- details of exemption from internal audit if applicable.

The Treasurer should make the necessary legislative amendment, incorporating the instruction in the Premier's Memorandum 91-3 on program evaluation, as well as the current legislative requirement to report action on significant matters raised by the Auditor-General arising from the external audit.

RECOMMENDATION 32

Compliance with annual reporting by chief executive officers of internal audit and significant matters raised by the Auditor-General should be policed by the NSW Treasury. The Auditor-General can be used to review accuracy of information.

RECOMMENDATION 33

To further strengthen the independence of internal audit from the operational parts of an agency, internal audit staff should not have any ongoing line management or other operational responsibilities within the agency. The NSW Treasury should amend the guidelines accordingly.

RECOMMENDATION 34

The internal audit section of an agency should not be used as a pool of staff to fill temporary vacancies in the agency, and so the NSW Treasury should amend the internal audit guidelines accordingly.

AUDIT COMMITTEES

In the private sector, audit committees have long been accepted as an effective means by which boards of directors can exercise proper control over the financial and related affairs of a business. An audit committee is a subcommittee of the board, typically comprising three to five non-executive members.[219] It is the board's watchdog on the organisation—its channel into the organisation's operational and financial activities to obtain all of the necessary information for the board to understand the organisation.

As we emerge from the economic downturn and corporate collapses of the late 1980s, there has been an increasing call for making more and better use of audit committees in the private sector:

- Could audit committees have assisted boards of directors and managements to avoid some of those corporate collapses?
- Where collapses occurred despite the presence of audit committees, did those committees have the right make-up and charter?

In its inquiry, the Public Accounts Committee gave a lot of thought to the appropriateness of audit committees in the public sector. To do this has required a review of audit committees in the private sector, both overseas and in Australia, as well as consideration of the use of audit committees already established in the New South Wales public sector.

The argument "for"

Audit committees appear to have arisen in the 1940s in the USA, following a recommendation of the US Securities and Exchange Commission for the establishment of committees composed of non-officer members of boards of directors to appoint the external auditors and arrange the details of the audit engagement.[220]

In the 1960s and 1970s a series of corporate collapses in the USA resulted in calls for the whole structure of corporate governance and regulation to be overhauled. The requirement for compulsory audit committees was advocated in many reports and papers.[221]

In Canada in 1967, the Select Committee on Company Law stated that:

> It is generally agreed that one of the most serious threats to the independence of the auditor is the close relationship which frequently (and naturally) develops between management and the auditor. . . In carrying out his role, the auditor not infrequently can feel under pressure to follow the dictates of [management]. To

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[219] Arthur Andersen, 1993: *Audit Committees in the 1990's*, Australian Institute of Company Directors, pp. 15–16.

[220] P. W. Wolnizer, 1978: Corporate audit committees and the independence question. *The Chartered Accountant in Australia*, August 1978, pp. 176–82.

[221] ibid., p. 177.

> avert this threat to the auditors' independence, the Committee recommends that . . . there shall be an audit committee of the Board of Directors.[222]

In the USA twenty years later, the National Commission on Fraudulent Financial Reporting (also known as the "Treadway Commission" after the chairman) noted that "The audit committee of a company's board of directors can play an important role in preventing and detecting fraudulent financial reporting."[223] The Commission recommended:

> The board of directors of all public companies should be required by SEC rule to establish audit committees composed solely of independent directors.[224]

In Canada, a major study into the public expectations of audits was undertaken from February 1986 by a commission of inquiry established by the Canadian Institute of Chartered Accountants. The study reviewed the functions of audit committees and concluded that the accountability function of directors, the effectiveness of the audit function, and the independence of the audit could be enhanced if the concept of audit committee was given statutory recognition. The Commission recommended:

> The CICA should enlist the support of provincial institutes and other interested bodies in seeking legislative amendments that would require all public companies to have audit committees composed entirely of outside directors.[225]

A legal requirement for audit committees has now been established in Canada.

In the United Kingdom, a study by a committee chaired by Sir Adrian Cadbury was undertaken into the financial aspects of corporate governance. A draft report released in July 1992 discussed the role of directors and the responsibility for internal controls in a business, and recommended:

> . . . all listed companies should have established effective audit committees within the next two years.[226]

In Australia in 1990, Price Waterhouse and the Australian Society of CPAs jointly published a booklet on guidelines for audit committees. The guidelines recommend that the terms of reference for an audit committee should be defined by the board of directors, and should include, among others, the responsibilities for reviewing:

- reports issued by the external auditors, and plans by management to rectify any matters noted;

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[222] Ontario Legislative Assembly, 1967: *Interim Report of the Select Committee on Company Law*, Toronto. Cited in Wolnizer, op. cit., p. 178.

[223] J. C. Treadway et al., 1987: *Report of the National Commission on Fraudulent Financial Reporting.*, p. 39.

[224] ibid., p. 40.

[225] W. A. Macdonald, 1988: *Report of the Commission to Study the Public's Expectations of Audits*, The Canadian Institute of Chartered Accountants, June 1988, p. 38.

[226] A. Cadbury et al., 1992: *Draft Report of the Committee on Financial Aspects of Corporate Governance*, London, p. 17.

- effectiveness of the internal audit function (or the desirability of establishing such a department);
- reports issued by the internal auditors and plans by management to rectify any matters noted;
- co-ordination of audit approach between internal and external auditors;[227]

In a survey of 1200 listed companies reported in March 1993, Arthur Andersen concluded that there were definite benefits of a listed company having an audit committee. The most important evidence in support was that companies with audit committees:

- took a more active role in assessing the risk of fraudulent or otherwise misleading financial reporting;
- were more active in raising accounting and regulatory issues with both the management and external auditors;
- used the committee to focus on regulatory requirements and internal controls.[228]

In November 1991, the House of Representatives Standing Committee on Legal and Constitutional Affairs recommended that Australian Stock Exchange rules be amended to require all listed companies to establish an audit committee.[229] In a subsequent exposure draft on proposed listing rule amendments, the Exchange encouraged the establishment of audit committees and flagged this as an issue for consideration.[230]

In New South Wales, the case for audit committees in government agencies has been advocated by both the Auditor-General and the NSW Treasury. In his 1989 Report to Parliament, the Auditor-General addressed the general question of audit committees and noted:

> Organisations today face growing pressures from increases in size, in the number of activities they undertake and in the complexity of their systems. At the same time, there are added calls for improved disclosure of information relating to management and performance. This is particularly relevant in the public sector.
>
> One way some organisations might better cope is through the establishment of audit committees.[231]

The NSW Treasury guidelines on internal audit advise:

> The Head of an Authority should, wherever practicable establish an audit committee chaired by the Head of the Authority.[232]

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227 Price Waterhouse and Australian Society of CPAs, 1990: *Audit Committees: a Working Guide*, p. 7.

228 Arthur Andersen, 1993: *Audit Committees in the 1990's*, Australian Institute of Company Directors, p. 8.

229 Cited in Joint Statutory Committee on Corporations and Securities, 1992: *Audit Committees—An Issues Paper*, Parliament of the Commonwealth of Australia, December 1992, p. 4.

230 Australian Stock Exchange, 1992: *Exposure Draft on Proposed Listing Rule Amendments and Other Issues*, October 1992, p. 60.

231 *New South Wales Auditor-General's Report for 1989*, Volume 2, p. 114.

232 NSW Treasury, 1990: *Internal Audit: Guidelines for Government Organisations*, p. 14.

It is somewhat surprising to note that in Australia the call to introduce audit committees has not been accompanied by a call for legal backing. For example, the Auditor-General said in his 1989 report: "I am of the opinion that it is not necessary to have such legislation in this State."[233] Rather, the emphasis has been on the voluntary introduction of audit committees.

In their submission, Ernst & Young recommended audit committees for "all entities of significant size and/or complexity". They also recommended:

> . . . for the purpose of assisting non-auditors (i.e. the Audit Committee members) to better understand whether the internal audit unit is most effective, that the Audit Committee should also include an independent professional auditor, businessman, business advisor, industry specialist, or management consultant.[234]

The Committee feels that the addition of such an outsider on the audit committee would certainly increase the independence of the committee. However, as the outsider would not normally be part of the normal accountability relationships in the public sector, the role and responsibility of such a position would have to be made very clear.

Carrying this idea one step further, the Committee suggests that there may be merit in including a representative of the relevant minister on the audit committee. This would recognise the special accountability relationship in the public sector between government agencies and their ministers.

The argument "against"

The Committee feels that the evidence to support the use of audit committees is indeed strong, but notes that some reservation has been expressed in some forums, including hearings for this inquiry, about audit committees. Some views have been put that the roles of audit committees might be unclear and overlap legal responsibilities of directors and company officers.

In an article entitled *Audit committees—everyone wants it, so where is it?*, Walker raised the issue that the role and function of audit committees may not be understood:

> Questions about the purpose of an audit committee should be on top of the list as one's views about the functions of audit committees will affect one's judgments about the details of membership, lines of communication, powers, duties, and so forth.[235]

Frith questioned whether audit committees are of any real value as follows:

[233] *New South Wales Auditor-General's Report for 1989*, Volume 2, p. 116.

[234] S5, p. 7.

[235] R. J. Walker, 1993: Audit committees—everyone wants it, so where is it?, *New Accountant*, 4 February 1993, p. 17.

> At the most fundamental level . . . establish just what contribution audit committees make to corporate governance: whether they are of real benefit or contribute nothing more to corporate governance than a warm inner glow.[236]

In evidence to the Committee, Professor Alan Craswell from the University of Sydney expressed an uncertainty about audit committees:

> I think that the question of audit committees is one that I for one have a little uncertainty about because I am not quite sure what the purpose of an audit committee is. There has been a suggestion that the audit committee is there to provide the auditor with access to the directors; but if you think about the role of an auditor, I cannot really understand why an auditor needs a committee in order to raise matters before the board. What I think the audit committee is there for is to provide the directors with access to the auditor, an access that is around the management because I think that is the problem you have.[237]

Audit committees in the public sector

As mentioned above, in New South Wales, both the Auditor-General and the NSW Treasury have advocated the use of audit committees as a means of addressing the tendency for government agencies to manage increasing amounts of money and other assets, with numerous objectives and increasingly complex systems, simultaneous with increased requirements for accountability.

New South Wales survey

Lynn Barkess and James Guthrie of the University of New South Wales, in association with the Internal Audit Bureau, have recently surveyed the New South Wales public sector with regard to audit committees. The survey of 212 agencies yielded 110 responses, of which 51 agencies advised that they had audit committees.[238] Of the possible 450 agencies reported on by the Auditor-General, only 212 were deemed by the survey team to be large enough or separately identifiable to be included in the survey. Most of those excluded were either a small function of a larger body, regulatory boards, or agencies with turnover of less than $1 million.[239]

The results of the University of New South Wales survey supported Arthur Andersen's findings for the private sector that the larger agencies tend to have audit committees. Using expenditure, revenue and equivalent full-time staff equivalents as measures of size, the NSW survey found that on average, agencies with audit committees are at least ten times larger than those without audit committees (table 2).

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[236] B. Frith, 1992: Audit committees. *The Australian*, 30 December 1992, p. 28.

[237] Minutes of Evidence, p. 97.

[238] S7 and L. Barkess & J Guthrie, 1993: *Public sector audit committees are different*, paper presented at IIR Conference on *Internal control and audit—improving accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney, p. 8.

[239] S9, p. 23. Note that some of the figures have been changed slightly following completion of the survey.

Fifty-four respondents believed that audit committees should be mandatory for public sector agencies (table 3), and on average these were also larger agencies than the 56 that did not support mandatory audit committees.

TABLE 2

SIZE OF AGENCIES WITH AND WITHOUT AUDIT COMMITTEES

Item	Agencies with audit committee	Agencies without audit committee	Entire database
Average gross expenditure	$461.0m	$47.6m	$236.9m
Average gross revenue	$404.4m	$30.8m	$201.3m
Average staffing levels	4371	385	2214

Source: L. Barkess & J. Guthrie, 1993: *Public sector audit committees are different,* paper presented at IIR conference on *Internal control and audit—improving accountability and management,* 3 & 4 May 1993, The Golden Gate, Sydney, p. 8.

TABLE 3

SHOULD AUDIT COMMITTEES BE MANDATORY?

Mandatory	Total	Agencies with audit committee	Agencies without audit committee
Yes	54	43	11
No	56	8	48
Total	110	51	59

Source: L. Barkess & J. Guthrie, 1993: *Public sector audit committees are different,* paper presented at IIR conference on *Internal control and audit—improving accountability and management,* 3 & 4 May 1993, The Golden Gate, Sydney, p. 8.

The most common size for the audit committees surveyed was four, but there was a tendency for the public sector audit committees to be larger than their private sector counterparts.

Audit committees in the public sector were found to contain both internal and external members. It was difficult to make a meaningful comparison of the membership of private sector versus public sector audit committees. However, one interesting finding was the inclusion of the external auditor in 12 of the 51 New South Wales audit committees, which directly contravenes the NSW Treasury guidelines.

A major difference found between the scope of public and private sector audit committees was that the former were concerned mostly with internal audit, and the latter were more concerned with external audit and financial reporting.

After comparing the results of their survey with Arthur Andersen's private sector survey, Guthrie and Barkess concluded that "it is necessary to provide legislation to establish ACs, if the widely recognised benefits of ACs are to accrue in both the public and private sector environments."[240]

Public sector accountability

The main difficulty in dealing with audit committees in the public sector is the different accountability requirements of the public sector compared to the private sector. In a Westminster type of government such as we have in New South Wales, government agencies are directly responsible to their ministers, who are in turn responsible to the Parliament, and most agencies do not have structures that are analogous to boards of directors.

Some agencies *do* have boards of management, and in such cases the private sector model seems quite appropriate, and audit committees could be made up of the non-executive members of the boards. It has to be realised that these boards are still subject to the control of the minister, and this is enshrined in legislation. If we want a legal requirement for audit committees, then we have to be careful how we fit this into the chain of ministerial responsibility.

In the other agencies without boards, whether government departments or statutory authorities, the chief executive officer is directly responsible to the minister, and the preferred membership of an audit committee is rather more difficult to determine. In organisations from which the Committee has heard evidence about their audit committees,[241] it is clear that such committees are quite different in structure and role from audit committees in the private sector or audit committees of boards of management

[240] L. Barkess & J Guthrie, 1993: *Public sector audit committees are different*, paper presented at IIR Conference on *Internal control and audit—improving accountability and management*, 3 & 4 May 1993, The Golden Gate, Sydney, p. 8.

[241] Department of Industrial Relations, Employment, Training and Further Education; Roads and Traffic Authority; Department of Community Services; and Department of Sport, Recreation and Racing all have audit committees comprising executive management, while none has a board of management.

of government agencies. These differences are so great that they prompt the Committee to make a fundamental distinction between audit committees of the private sector model, and "executive audit committees" of government agencies without management boards.

Pacific Power

The Auditor-General used Pacific Power as a model example of an organisation with an audit committee of the board.[242] In the Committee's subsequent survey of internal audit, it came to light that Pacific Power also operates an "Executive Audit Review Committee". The Committee felt that it would be useful to illustrate how these two types of audit committees work in this large statutory body with both commercial and community service operations.

Pacific Power's Audit Committee (AC) of the Board of Commissioners was established two years ago in recognition for calls for private sector boards to establish audit committees. It comprises the Chairman of the Board, who is not an executive director, and two other non-executive directors, one of which is the Chairman of the Audit Committee. Its terms of reference are approved by the full Board.

The AC has three main functions:

- monitor the work of internal audit (which is done entirely in-house) and the Auditor-General, and review management letters from the Auditor-General
- co-ordinate the total audit coverage
- satisfies itself with the financial statements before submission to the full Board for approval.

The AC meets quarterly. At one of the annual meetings it meets firstly with the Auditor-General (or his representative), then with the Manager of Internal Audit, and finally with the Executive of Pacific Power.

The focus of the AC tends to be "macroscopic", in that it is mainly concerned with exception reports on internal controls.

The Executive Audit Review Committee (EARC) in contrast takes a more microscopic view, and examines all internal audit reports in detail, and particularly management's response to those reports.

Membership of the EARC comprises the General Manger, the Secretary, the five assistant general managers, the Corporate Financial Controller, and the Manager of Internal Audit. The EARC was established earlier than the AC, and is referenced in the Internal Audit Charter. It is a powerful forum in which all problems identified by Internal Audit are laid on the table, and each manager knows that audit reports on his area of responsibility will be scrutinised by the whole Executive. This arrangement helps to strengthen the independence of the Internal Audit, and also encourages the senior managers of the organisation to deal with their own problems.

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242 Minutes of Evidence, p. 145.

There is no direct contact between the EARC and the Auditor-General, but minutes of all EARC meetings, which are also held quarterly, are submitted to the Auditor-General.

The Committee feels that there are elements of these two types of audit committees which would contribute to increased management accountability in all large agencies, regardless of whether they have management boards.

Should audit committees be mandatory?

After weighing up all of the evidence, the Public Accounts Committee has concluded that a properly structured audit committee which has clear responsibilities should be a major contributor to effective internal control and good corporate governance in any large organisation, be it in the public or private sector. But should audit committees be made mandatory in the New South Wales public sector, in line with mandatory private sector audit committees in Canada and the call for mandatory audit committees elsewhere?

Support for a legal requirement for audit committees in both the private and public sectors was conveyed to the Committee by the IIA-A.[243] The TAFE Commission also supported mandatory audit committees,[244] as did half of the respondents to the Barkess-Guthrie survey (table 3).

The Internal Audit Bureau provided the Committee with specific advice on audit committees in its submission.[245] The Bureau noted that there seemed to be an inconsistent approach to the composition and role of audit committees in the New South Wales public sector, and recommended to the Committee that the role, composition and responsibility of audit committees be better defined, and that small organisations should not be required to have audit committees. To the Public Accounts Committee this seems reasonable. However, the Committee was rather surprised that the Bureau recommended that audit committees in large organisations should *not* be made mandatory, and maintained that:

> Accountability controls are sufficient to monitor all aspects of an organisations performance. An audit committee should be an option for management to consider depending on the circumstances of the organisation.[246]

Although the NSW Treasury's guidelines on internal audit could be said to have indirect legal backing through being referred to in the Treasurer's Directions, as indicated on page 20, the Committee feels that the requirement for audit committees through guidelines is just not strong enough.

Despite the advice from the Internal Audit Bureau, the Committee can find no good reason why large government agencies with boards of management should not be required to have independent audit committees of the private sector model. In fact, it seems to the Public Accounts Committee that one of the main *responsibilities* of a board of

[243] S6, p. 7, and Minutes of Evidence, p. 6.

[244] S8, p. 5.

[245] S9, pp. 20-24.

[246] ibid., p. 24.

management should be to establish a subcommittee to oversee co-ordination of internal and external audit. It should therefore fall to the NSW Treasury to develop criteria for determining which agencies *do* warrant mandatory audit committees, probably based on some measure of size or financial risk. The internal audit guidelines also need strengthening in their treatment of audit committees.

RECOMMENDATION 35

All boards of management of large government agencies should establish audit committees of non-executive board members, and the Treasurer should provide legislation accordingly. Such audit committees should be required to comply with a revised section on audit committees in the NSW Treasury's guidelines on internal audit. The NSW Treasury should also develop criteria for determining those agencies that warrant audit committees of boards.

RECOMMENDATION 36

The NSW Treasury should amend its guidelines on internal audit in regard to audit committees to ensure that the membership and relationships of public sector audit committees with internal and external auditors are consistent with best practice in the private sector. In particular, the audit committee should ensure liaison between the internal auditor, the external auditor, and the management of the authority. A further function is to review implementation by management of recommendations made in internal audit reports.

EXECUTIVE AUDIT COMMITTEES

For large agencies, again without being precise at this stage about how large or even how to define size, the Committee would like to encourage the establishment of executive audit committees, regardless of the existence of a management board. The model of an executive audit committee provided by Pacific Power is a good start, but agencies should not limit themselves to this particular example. There are two options that could be considered:

- An executive audit committee could include experts from outside the agency to act in an advisory role. Such experts could include a representative from an accounting firm, the Internal Audit Bureau or a central government agency, a business executive from the private sector, or a representative from the agency's clients. This would be particularly useful for those agencies without boards.

- If the executive audit committee did not include the chief executive officer, it would have some degree of independence.

Some combination of the attributes of Pacific Power's Audit Committee and Executive Audit Review Committee could well be used to establish executive audit committees in those large agencies without boards. The Committee was heartened when the Acting Chief Accountant of the NSW Treasury said that:

> . . . the way I see it is that the principle benefit of having the [executive audit] committee is that you get a forum in which people can talk and exchange information, and also to co-ordinate.[247]

The Committee firmly believes that executive audit committees constitute another area of management reform that the NSW Treasury should research in order to improve the internal audit guidelines.

Linda English advocated parliamentary oversight of audit committees in general, and suggested that this could be effected by requiring the Auditor-General to report on the functioning of audit committees.[248] The Committee fully agrees with this concept.

RECOMMENDATION 37

Large agencies should also establish "executive audit committees", and the internal audit guidelines should be amended by the NSW Treasury accordingly. The guidelines need to provide useful advice on the structure, functions and responsibilities of executive audit committees.

RECOMMENDATION 38

Ongoing parliamentary oversight of audit committees is desirable. This should be effected by the Treasurer amending the legislation to provide that, as part of the annual external audit, the Auditor-General should review the functioning of audit committees and executive audit committees, and then present his findings in the Auditor-General's reports to Parliament. This will include review of the way the committees handle internal audit matters other than financial compliance matters.

[247] Minutes of Evidence, p. 225.

[248] S4, p. 6.

PART III

WITHIN THE INTERNAL AUDIT

CHAPTER 7: RESPONSIBILITIES OF THE INTERNAL AUDIT

AUDIT PLAN

The Internal Audit Bureau explained to the Committee in its submission that the development of a long term audit plan by the audit manager for an agency is essential to determining the number and type of skills that are required for internal audit.[249] The planning process involves the identification of all the auditable units within the agency, and making an assessment of the risks that each of these auditable units presents to the agency. This list should be evaluated for the resources required to conduct the reviews in terms of time, skills required, and frequency of review, and then evaluated for priorities. The end result is a long term plan, a skill profile, and an indication of how many hours work is required annually to complete the audit program. The long term plan must be endorsed by the chief executive officer as part of the internal audit charter.

An annual plan is derived from the long term plan, based on resources made available by the CEO, internal audit's assessment of risk, and planned liaison with the external audit. The audit manager should seek approval from the chief executive officer for each annual audit plan.

The internal audit manager must then ensure that each audit assignment is properly planned, including allocation of audit time to each major segment of the assignment.

The NSW Treasury guidelines on internal audit outline the three levels of planning required to operate the internal audit organisation efficiently, and refer to the planning process as follows:

> The audit manager should ensure that plans are established to carry out the responsibilities of the internal auditing organisation. The plans should be consistent with the Internal Audit Charter and with the goals and objectives of the Authority.[250]

The Internal Audit Bureau recommended to the Committee that these guidelines:

> be expanded to explain the detailed process required to prepare a complete and effective plan for the conduct of the internal audit function. From this planning process, management would be in a much better position to identify the resources and hence the size required to conduct the internal audit function.[251]

The Committee finds this to be a most constructive suggestion, as it would greatly assist the chief executive officer in discharging his/her responsibility for providing resources for internal audit. However, the planning must be realistic, and the chief executive needs to

[249] S9, p. 26.

[250] op. cit., p. 14.

[251] S9, p. 27.

be assured of this. Commissioner Temby told the Committee's seminar on internal control and audit about unrealistic audit plans he has seen in the New South Wales public sector:

> I am aware of organisations in this State that have very small internal audit sections which have a list of over 1000 projects to be embarked upon, and realistically it would be 16 or perhaps 160 years before the end of that list could be achieved. That cannot be sensible. Either the list is absurdly long or the internal audit section is absurdly small.[252]

The Committee considers that the planning process is sufficiently important to be enshrined in standards, as this would provide some degree of assurance to the CEO. The most relevant professional guidance on audit planning is provided by AARF's Statement of Auditing Practice AUP10—*Planning*.

RECOMMENDATION 39

Greater assistance to chief executive officers is required for them to fully appreciate the internal audit planning process and use it to allocate resources for internal audit. The NSW Treasury should amend the internal audit guidelines to explain the detailed process required to prepare an effective plan for the conduct of the internal audit function, and to show how this planning process should be used by management to assist in determining the appropriate resources required for the internal audit function.

RECOMMENDATION 40

In the standards to be adapted in accordance with Recommendation 3, the NSW Treasury should incorporate Statement of Auditing Practice AUP10—*Planning*, suitably augmented to include the broad scope objectives of internal audit, to assist internal audit managers with the planning process.

REPORTING RESULTS OF AUDIT

Legal requirements for reporting the results of internal audit are clearly stated in s. 11(2)(c) of the Public Finance and Audit Act, which provides for "the reporting directly at regular intervals to the Head of the authority as to the result of any appraisal, inspection, investigation, examination or review made by the internal audit organisation."

Once the chief executive officer has established the internal audit function, it is the responsibility of the internal auditor to report the results of audit in compliance with the

[252] Public Accounts Committee, 1973: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, p. 17.

Act. Further professional guidance for internal audit is provided by the IIA's *Standards for the Professional Practice of Internal Auditing*:

> *430* **Communicating Results**
> *Internal auditors should report the results of their audit work.*
>
> *.01* A signed, written report should be issued after the audit examination is completed. Interim reports may be written or oral and may be transmitted formally or informally.
> *.02* The internal auditor should discuss conclusions and recommendations at appropriate levels of management before issuing final written reports.
> *.03* Reports should be objective, clear, concise, constructive and timely.
> *.04* Reports should present the purpose, scope, and results of the audit; and, where appropriate, reports should contain an expression of the auditor's opinion.
> *.05* Reports may include recommendations for potential improvements and acknowledge satisfactory performance and corrective action.
> *.06* The auditee's views about audit conclusions or recommendations may be included in the audit report.
> *.07* The director of internal audit or designee should review and approve the final audit report before his issuance and should decide to whom the report will be distributed.[253]

The Australian Accounting Research Foundation has also issued specific guidance to auditors in reporting on the results of audit: AUP3—*The Audit Report on a General Purpose Financial Report*, and AUP3.2—*Special Purpose Auditors' Reports*. The application of these statements of audit practice to internal audit is currently open to general comment through the issue in August 1989 of exposure draft ED29 on *Statement on Applicability of Statement of Auditing Standards and Statements of Auditing Practice to Internal Auditing*.

The Victorian Economic Development Corporation case illustrates ineffective internal audit reporting in a statutory body. In the VEDC, the internal audit function was undertaken on a contract basis by a firm of chartered accountants. Fergus Ryan concluded that the issue of management letters on the adequacy and effectiveness of internal controls was inadequate, and pointed out significant delays in producing other audit reports.[254]

The legal reporting requirement on public sector internal audit in New South Wales is not matched by a similar requirement for the private sector. However the requirement to report is to the chief executive officer, and not to a management board for those agencies which have such boards.

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[253] The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, Florida, pp. 40–45.

[254] F. Ryan, 1989: *Report of Inquiry, Victorian Economic Development Corporation*, Victorian Legislative Assembly, Melbourne, pp. 55–57.

A similar situation has been noted in the private sector by Walker:

> Even though private sector auditors spend a great deal of time assessing internal controls, reports on these matters are generally directed to management, rather than to directors, regulatory agencies or shareholders.[255]

The Committee has used this point in considering audit committees (page 121).

Some other points about reporting the results of internal audit have provoked the Committee to comment:

- Internal audit must not only report risks, deficiencies and problems, but also recommend action for managing risk and overcoming deficiencies and problems. That is, the reports must be positive and helpful, not a hindrance. Recommendations must consider the desired outcomes rather than just focus on the processes.

- Internal audit has a responsibility to ensure that its reports are comprehensible to the chief executive officer and the audit committee, particularly the latter, which may include members not fully conversant with the details of the agency's operations. Again, the report must be helpful.

- Internal audit reports need to be acted upon, and that action needs to be followed up by both internal audit and external audit (see page 106).

Several speakers at the Committee's seminar on internal control and audit spoke about "whistleblowers". Mr Temby said:

> It is essential that people should be encouraged to bring to notice matters which are of concern to them, whether they have to do with either apprehended corruption or criminality or whether they simply have to do with marked incompetence and inefficiencies. It is essential that people be encouraged to bring these matters to attention.[256]

Legislation to protect whistleblowers has been suggested as one way to encourage serious fraud and corruption to be brought into the light, and such a Bill is currently under consideration by another parliamentary committee. In the Public Accounts Committee's opinion after having conducted this inquiry into internal audit, if internal audit is properly structured and resourced, with a strong reporting link to the chief executive officer, ideally there should not be any need for whistleblowers.

At the end of the day, however, internal control and internal audit involve the interaction of key personalities and the exercise of power in organisations as much as they involve the drafting of intricate formal requirements, rules and regulations.

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[255] R. J. Walker, 1992: Reporting weaknesses in internal controls. *New Accountant*, 23 July 1992, p. 9.

[256] Public Accounts Committee, 1993: *Proceedings of the 90th Anniversary Seminar on Internal Control and Audit*, Report No. 69, p. 19.

Even a set of internal control and audit guidelines, standards, and regulations the size of the Sydney telephone directory will not be any guarantee against the unscrupulous exercise of power.

In every case it is a question of whether or not individuals are prepared to speak up on problems. This is true of both the public and private sectors.

ASSURING QUALITY OF AUDIT

Standards for audit quality control

Through the Australian Accounting Research Foundation, the professional accounting bodies have issued guidance on quality control to auditors in the form of a Statement of Auditing Practice AUP13—*Control of the Quality of Audit Work*. Although developed with a view to the external auditor, the statement is appropriate to be used by internal audit managers to develop quality control systems.

During the hearings, the Committee asked representatives of the professional accounting bodies about their bodies' views on quality assurance:

> **Mr Chappell:** What is the position of professional bodies in relation to peer review and quality assurance reviews of internal auditors' work?
> **Mr Spencer:** I do not think that the Institute has promulgated anything in respect of internal audit work. It has a program of voluntary peer review for external auditors, but I am sure it would encourage peer reviews for internal audit also. Where the internal audit operation is a reasonable sized operation, it would be usual for the external auditor to liaise very closely with them, and part of his responsibility then under AUP2 is to evaluate the work of the internal auditor. So in some respects there is an on-going peer review, a peer review if you like, of the internal audit function. That review would include the charter of the internal audit department, their audit plan, their reporting lines, the qualifications of their staff, staff training, and matters such as those.
> **Mr Smith:** I think the Society would agree with that, and it is a matter of not being over-bureaucratised. Generally you would rely on the external auditor reviewing the program and finding it acceptable.[257]

The IIA has issued more specific guidance on quality control for internal auditors. According to the IIA's standards, a manager of internal audit should establish and maintain a quality assurance program to evaluate the operations of the internal audit unit.[258] The quality assurance program should include the elements of supervision, internal reviews and external reviews.

[257] Minutes of Evidence, p. 19. Mr Spencer represented The Institute of Chartered Accountants in Australia, and Mr Smith represented the Society of Certified Practising Accountants.

[258] The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, Florida, pp. 54–60.

Adequate supervision is the most fundamental element of a quality assurance program. This is the responsibility of the manager of internal audit, who should:
- ensure adequate planning and suitable instructions to audit staff;
- determine that the approved audit program has been carried out and documented and that the resulting report comments are appropriate.

Supervision should be performed throughout the planning, examination, evaluation, report and follow-up process for all audit jobs. Supervision should also extend to education and training, employee performance evaluation, and time and expense control.

Internal reviews should be performed periodically by members of the internal audit staff to appraise the quality of the audit work performed. These reviews should be performed in the same manner as any other internal audit. They are generally performed by a team or an individual selected by the manager of internal audit. Larger internal audit units might have a quality assurance officer. Alternatively, the manager of internal audit may undertake the reviews.

Feedback from auditees (in addition to that derived from personal contact) through the use of questionnaires or surveys—either routinely after each audit or periodically for selected audits—is another form of internal review.

External reviews are performed by qualified people who are independent of the agency and therefore do not have a real or apparent conflict of interest. The standards advise that such reviews should be undertaken every three years, and should report compliance with the IIA's standards and include recommendations for improvement, where appropriate.

The manger of internal audit should discuss with senior management of the agency and the audit committee the nature of an external review in the context of the overall quality assurance program, and should involve them in the selection of the external reviewer.

Value of internal reviews

On page 70, the Committee referred to the complex internal audit system in the Department of Health. The Committee was interested in ascertaining how the State's largest government agency ensures that its internal audit is working properly, and whether any aspects could be applied to other agencies. Tony Clarke—the Director of Audit—explained his Department's approach to internal reviews:

> **Mr Clarke:** All of the internal audit units in that system are required to comply with standards issued by The Institute of Internal Auditors for the professional practice of internal auditing. One of the functions of my unit [the "corporate" audit unit] is to do reviews of the other internal audit units to make sure that they are complying with those standards.
> **Mr Chappell:** Do you do spot checks?
> **Mr Clarke:** When we go out to do an audit of a country region for instance we do a fairly extensive review of the internal audit function in the region, and in accordance with quality assurance review standards that are laid down by The Institute of Internal Auditors it may not always be a full review but it is certainly in all instances a partial review, and we have dome some full quality assurance reviews of internal audit in area health services. So that is the way we get the

> internal audit units performing, and through time the quality of their internal audit work has improved dramatically. We still have some way to go, though. [259]

The Committee understands that most agencies, even those that are highly regionalised, have only one level of internal audit rather than the complex matrix system of the Department of Health. However, Geoff Johnston mentioned in his submission his concerns about regionalisation of internal audit in one relatively small but highly decentralised agency:[260]

- collegiate support is lost
- possibility of regional internal auditors being subjected to undue pressure from regional management
- regional internal audit no longer reports directly to the chief executive officer
- regionalisation leads to loss of specialisation in internal audit.

Johnston maintained that regionalisation reduced internal audit independence and effectiveness.

For small agencies, the Committee agrees with Johnston's view, and favours a centralised internal audit unit whose manager is clearly responsible to the chief executive officer. However, the Committee also sees merit in the Department of Health model for large agencies where internal reviews are well established (although the Central Sydney Area Health Service shows that this model is not perfect—see page 90).

RECOMMENDATION 41

Regionalisation and decentralisation of agencies, together with devolution of line management responsibility, have increased the difficulty of providing effective internal audit. The NSW Treasury should include in the internal audit guidelines advice on internal reviews of internal audit to agencies which have audit staff outposted to regional centres or subsidiary divisions or branches away from the main audit unit.

[259] Minutes of Evidence, pp. 49–50.

[260] S3, pp. 2–3.

Appropriateness of external reviews

In its report on the Auditor-General's Office, the Committee recommended a three-yearly review of the Office by a peer review auditor, with review reports to be tabled in Parliament together with comments by the Auditor-General.[261] This recommendation has since been enshrined in the Public Finance and Audit Act, with the Public Accounts Committee made responsible for appointing the peer reviewer.[262]

In hearings, Jim Kropp gave the Committee his views on external quality assurance reviews:

> As far as quality assurance is concerned, my firm [Price Waterhouse] has produced a publication called *Does Your Internal Audit Department Measure Up?* and that includes at the end of it a section on external quality assurance reviews and we recommend that external quality assurance reviews be conducted on internal audit departments from time to time. . . In my own practice I am subject to quality assurance reviews every three years.[263]

Ernst & Young and the Internal Audit Bureau also advocated three-yearly quality assurance reviews of internal audit.[264] The Committee agrees that a system of peer review of internal audit is appropriate for public sector internal audit, and should complement proper internal audit supervision and internal reviews. Reports of external peer reviews of internal audit would provide valuable indicators of the effectiveness of the overall internal control systems operating within the agency.

Traditionally, internal audit has been assessed by the external auditor as part of the external audit itself. Audit standards and statements of audit practice by the AARF provide guidance to external auditors in the use of internal auditors' work.[265] Where the external auditor is satisfied with the quality of the internal auditors' work, the procedures of the external audit can be reduced (but not eliminated). This evaluation of internal audit is designed to assist the external auditor in the primary task of forming an opinion on the financial statements. It does not provide a comprehensive quality assurance review of internal audit in its broadest sense.

The Committee wants to clearly establish that it views periodic comprehensive external reviews of internal audit in the New South Wales public sector as additional to the ongoing oversight of internal audit by the Auditor-General in conducting the statutory external audit. The Auditor-General, the Internal Audit Bureau, or some other independent audit organisation could be contracted to undertake the periodic reviews envisaged by the Committee. With the move towards a broader and more comprehensive scope of internal audit, such reviews should help to ensure a consistency of audit

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261 Public Accounts Committee, 1990: *Report on the New South Wales Auditor-General's Office*, Report No. 49, p. 173.

262 s. 48A.

263 Minutes of Evidence, p. 188.

264 S5, p. 6; S9, p. 19.

265 Statement of Auditing Practice AUP2—*Using the Work of an Internal Auditor.*

approach. That is, when the quality of audit is high, one would expect that different auditors who audit the same operation should arrive at the same results.

Peer review of Internal Audit Bureau

The Committee noted that the Internal Audit Bureau's enabling legislation—the *Internal Audit Bureau Act 1992*—does not provide for a peer review function. This is inconsistent with the situation regarding the Auditor-General's Office and the thrust of the preceding section, and warrants rectification.

RECOMMENDATION 42

In developing public sector internal audit standards (see Recommendation 3), the NSW Treasury should provide for quality assurance programs, including three-yearly external reviews, in line with the internal audit standards issued by The Institute of Internal Auditors Inc.

RECOMMENDATION 43

To be consistent with statutory peer review arrangements for the Auditor-General's Office, the Internal Audit Bureau should be subject to three-yearly external reviews. The Treasurer should amend the Bureau's enabling legislation accordingly.

ACCREDITATION AND TRAINING OF AUDITORS

The competency factor

This section reviews the processes for the training and accreditation of auditors and the development of competency based standards for professional occupational groups in Australia.

Internal auditors until the most recent times have been recruited with a background in accounting.

In Australia there is no statutory recognition or reservation of the job titles "accountants" and "auditors"—the one exception being a registered company auditor under the Corporations Law. Anyone can call himself or herself an accountant or an auditor, and it is up to individual employers to assess whether or not individual employees possess the required skills and experience to satisfactorily perform specific work tasks.

At the time of writing this report, the Committee became aware of moves for a bill to be introduced into Parliament to provide for registration of accountants. The details of the proposal were unknown, but the Committee encourages any move to give statutory protection to the title of accountant, auditor and internal auditor to persons who hold appropriate qualifications and experience and are of good character.

The professional bodies have in place systems to assess levels of education and experience appropriate to meet the self-determined entry requirements for each body. In written submissions to the committee, two professional bodies gave details of their accreditation programs.

The Australian Society of CPAs advocated the Australian qualification of CPA (Certified Practicing Accounting) as being an appropriate measure:

> An efficient way of ensuring appropriate qualifications is to use the qualifications of professional bodies as a means of screening. That is, for career internal auditors in the public sector, advancement should be conditional upon professional qualifications.
>
> There are two types of qualifications: as qualified accountants or as qualified internal auditors.
>
> The rules of the Australian Society of CPAs are designed to ensure that CPAs have the necessary academic and professional qualifications to carry out the functions of modern day accountants and the requirements for continuing education ensure that members maintain their level of expertise in accounting and auditing.
>
> A qualification as an internal auditor that does not have the stringent initial vetting of qualifications for admission or the requirement to maintain a high level of expertise would not satisfy the demands of the public sector. Internal auditors clearly need to have accounting and auditing training and experience.
>
> To require public sector internal auditors to be members of the Australian Society of CPAs will ensure a quality control.[266]

The Institute of Internal Auditors—Australia advocated the Institute's standards as indicating appropriate levels of skill:

> The Internal Auditing Department should possess or should obtain the knowledge, skills, and disciplines needed to carry out its audit responsibilities. This may include contracting in suitable skills.
>
> The Internal Auditing staff should collectively possess the knowledge and skills essential to the practice of the profession within the organisation. These attributes include proficiency in applying internal auditing standards, procedures, and techniques.[267]

To ensure the ongoing quality of internal audit, the IIA has instituted a world-wide education program, including formal examinations, leading to the qualification of

[266] S14, p.2.

[267] S6, p. 15.

Certified Internal Auditor (CIA). 1991 was the first time these examinations were offered in New South Wales, with the New South Wales Branch of the Institute organising pre-examination tutorial sessions.

The Committee noted the apparent conflict in evidence from the two professional bodies. It was not the Committee's task to adjudicate on the relative merits of each education program, because these programs are not mutually exclusive. That is, prospective candidates for internal audit positions, after satisfying the entry requirements for each professional body, can complete either or both programs.

The Committee, however, reviewed the information on continuing education supplied by both bodies. The ASCPA's CPA program contains an optional module on auditing that includes a segment on auditing in the public sector under contemporary Australian conditions.

The IIA's CIA program, on the other hand, is developed in the United States and focuses almost entirely on internal audit issues. This program includes topics of management, quantitative methods, information systems, accounting finance and economics. The program as developed does not address contemporary issues in auditing in the Australian public sector.

The Committee's survey of internal audit included examination of the professional qualifications of internal auditors. The Committee found a wide variety of degrees, diplomas, certificates, and memberships of professional bodies. Very few audit staff were found not to possess or not be in the process of acquiring professional qualifications or status. The Committee is inclined to agree with the two professional bodies from which it heard evidence that membership of such bodies usually places an obligation on employees to act professionally, hold or acquire professional qualifications, and keep up-to-date in their chosen field of endeavour. The Committee has not tried to determine all of the professional bodies that might be appropriate to internal auditing, but they may be national or international, and include fields of accounting, auditing, information technology, engineering, environmental management, or even forestry.

Deloitte Ross Tohmatsu suggested to the Committee that internal audit staff should be encouraged to work towards obtaining a professional qualification, and a minimum of 75 hours per year should be allocated to each member of the internal audit unit for training.[268]

Self-regulation

Self-regulation is a concept dear to the heart of the various professions. The professional bodies, quite justifiably, place great pride in their ability to regulate their members. The professional bodies would resist attempts by government to regulate the affairs of the professions.

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[268] S11, p. 2.

The difficulties faced by the professional bodies in enforcing standards of skill and best practice have been discussed in the Parliament in very recent times. John Murray, MP—Member for Drummoyne and a former chairman of the Public Accounts Committee—said in Parliament:

> I draw the attention of the House to what I believe to be a laxity in current legislation which has allowed a disgraced and bankrupt accountant, . . . to continue to practise and, at the same time, to defraud members of the public.
>
> Unfortunately there is no legislation in New South Wales relating to the ASCPA being able to bar a member from practising after that person's membership has been revoked. I understand there is no Act of Parliament relating to accountancy and, further, that accountants are not required to be members of any regulatory body. This means that there is no government form of quality assurance within the profession. This is stark contrast with the legal profession, where lawyers cannot practise unless they are registered with the Law Society. Unfortunately, accountants can continue to practise after being struck off by their professional body.[269]

The Committee notes that regulation and control over accountants and auditors offering their services to the general public is not a simple task. The related question of control and regulation over internal auditors is further complicated by the master and servant relationship for salaried internal auditors and individual contractual arrangements for internal audit services which are contracted out.

Competency based standards

The development of competency standards for occupations in Australia is a relatively new development designed to improve the outdated process of specifying qualifications and experience as separate and, at times, unrelated requirements for specific jobs.

The development and recognition of competency standards, specifically developed for the Australian context, has been recognised by all levels of government as part of the process of industrial reform brought about by the recognition of the need "of Australia's economic structure to be internationally competitive."[270]

The development of competency standards for accounting and related professions was a task addressed by the professional accounting bodies in Australia in co-operation with the National Office of Overseas Skills Recognition—a unit of the Commonwealth Department of Employment, Education and Training. Advice to the Committee[271] indicated that accounting as a profession was divided into a number of functional areas which included auditing. Internal auditing was not regarded as a separate profession but was recognised as a sub-set of auditing.

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269 Hansard, 29 April 1993, p. 60.

270 National Training Board Ltd, 1991: *National Competency Standards: Policy and Guidelines*, Canberra, p. 4.

271 Correspondence from the Executive Directors of the Australian Society of CPAs and The Institute of Chartered Accountants in Australia to John Lynas, 24 April 1992.

The Committee was concerned at the prospect of internal auditing being seen as a sub-set of financially focussed auditing in the development of competency based standards for Australian professions. It is clear to the Committee that for internal audit in the public sector, a wide range of skills and qualifications is appropriate to address the broad scope of audit that is necessary for that sector. The Committee heard evidence that multi-skilled internal audit teams were a common occurrence in New South Wales government agencies.

For the Department of Health, it is common for nurses to be members of audit teams. The internal audit manager for an area health service advised the Committee:

> I have a multi-skilled internal audit function where I have nurses as part of our internal audit, which is absolutely vital in the health industry, with the jargon that goes on there. . . the Institute pushes for the technical competency of people to be able to carry out the function, and not just to be an accountant.[272]

The Roads and Traffic Authority is a statutory authority with a wide charter in designing, constructing and maintaining the State's road network and in the registration, licensing and testing of vehicles and drivers. The Authority plans to restructure its internal audit and engineering performance evaluation units into a combined group audit unit comprising staff with engineering skills in addition to finance trained auditors.[273]

The Department of Industrial Relations, Employment, Training and Further Education is responsible for administration of a wide range of programs. The Internal Audit Manager advised the Committee:

> We have a wide range of skills in the unit. When we have a special audit or project where we believe we need added expertise I approach the division being audited and ask whether it can second someone to the audit. Recently we have had a senior training officer seconded because we were evaluating training expertise in a number of organisations.[274]

Although the Committee has reservations about seconding staff from the division to be audited (page 102), this does illustrate the wide range of skills and experience required in internal audit.

As a final example, the TAFE Commission's audit group has staff qualified in many areas: accounting, financial management, statistics, investigation methods, industrial relations, compliance auditing, management analysis, auditing computer systems, social research, business practice, economics, education, psychology, sociology, mathematics, banking and criminology.[275]

The Committee acknowledges that New South Wales government agencies have developed different models to address the competency question for internal audit. However, the lack

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[272] Minutes of Evidence, p. 9.

[273] ibid., p. 85.

[274] ibid., p. 74.

[275] S8, p. 8.

of competency standards for internal audit and the absence of any statutory or other criteria to register or licence internal auditors is of concern.

The Committee was advised that the Accounting Policy Branch of the NSW Treasury is currently (May 1993) developing a policy on competency standards for accounting and finance-related staff for public sector agencies.

RECOMMENDATION 44

In recognition of the professional status of internal auditing, the NSW Treasury should amend the internal audit guidelines to require internal audit staff of in-house internal audit units to have evidence of or be working towards acquiring professional qualifications and related competency standards appropriate to auditing and/or the field in which the audit is being conducted.

RECOMMENDATION 45

The lack of competency standards for internal audit and the absence of any statutory or other criteria to register or licence internal auditors is a weakness. The NSW Treasury should develop competency standards for internal audit units in the public sector in co-operation with the Auditor-General, the Auditing Standards Board, The Institute of Internal Auditors—Australia, and relevant employee organisations.

CHAPTER 8: RELATIONSHIP BETWEEN INTERNAL AUDIT AND EXTERNAL AUDIT

This report has so far referred extensively to the Auditor-General, which is the most common organisation external to the agency that internal audit is likely to liaise with. In this chapter, the Committee focuses on the working relationship between internal audit and the Auditor-General (that is, staff of the Auditor-General's Office), and particularly on some problems that came to light in evidence collected during the inquiry.

When reviewing the ideal relationship between internal and external audit within the organistion it is important to consider the fundamental difference between the two audit functions.

The external auditor in both the public and private sectors performs a statutory audit function. That is, the scope of audit, the audit standards that are to be followed, and the reporting obligations of the auditor are defined in statutes. For the New South Wales public sector the external audit function is undertaken in accordance with the Public Finance and Audit Act, and for the private sector the Corporations Law prescribes the statutory basis for the external audit.

The internal auditor, on the other hand, is responsible to management and as discussed on page 80, management should establish an internal audit charter to define the role, function and responsibilities of the internal audit function in the organisation.

The working relationship between the external and internal auditor is the subject of auditing standards and practice statements for external auditors by the professional accounting bodies in Australia through the AARF, as well as internal auditing standards issued by the IIA.

The AARF's Statement of Auditing Practice AUP2 on *Using the Work of an Internal Auditor* sets out the standards to be followed by the external auditor in evaluating the work performed by internal audit. The Auditor-General explained to the Committee[276] that the external auditor reviews the internal audit working papers to obtain satisfaction that:

- The scope of work and related audit programs are adequate for the external auditor's purposes.

- The work was properly planned and the work of assistants properly supervised, reviewed and documented.

- Sufficient appropriate evidence was obtained to afford a reasonable basis for the conclusions reached.

[276] SO, p. 4.

- Conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed.

Finally, the external auditor is expected to test the work of the internal audit that is intended for use.

The actual relationship between the work of both the internal and external auditor can be summarised from AUP2:

> An adequate and effective internal audit function will often justify a reduction in the extent of procedures performed by the external audit, but cannot eliminate them.

The Committee accepts this view. The Committee also notes that the external auditor has a statutory obligation to audit, and as demonstrated by the AWA case, auditors can be held liable for damages if that audit is not conducted to appropriate standards.

The IIA's *Standards for the Professional Practice of Internal Auditing* specify that the director of internal auditing should co-ordinate internal and external audit efforts to ensure adequate internal audit coverage and to minimise duplicate efforts. Co-ordination of effort involves periodic meetings, access to each other's audit programs and working papers, and exchange of audit reports and management letters.[277]

The Committee accepts the view proposed in the IIA standards with the reservation that the obvious co-ordination between the two audit functions should not in any way take away the external auditor's responsibility to report to the shareholders of the entity. For the public sector, the Parliament is the ultimate authority to determine the total audit coverage.

ACCESS TO WORK PAPERS

Despite these standards on communication between the external auditor and internal audit, the Committee became aware of two problems regarding access to internal audit

The first case was raised by the Auditor-General, who said:

> We have one very large audit that we undertake, as I have suggested we do not have any contact with the internal audit area and that is bad. It is bad for us and it is bad for the management of that organisation because we are probably duplicating work.[278]

Clearly, this is not an appropriate situation. The Committee understands that the Auditor-General has since taken action to redress the problem, which appears to be an isolated incident.

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[277] The Institute of Internal Auditors Inc., 1989: *Codification of Standards for the Professional Practice of Internal Auditing*, Altamonte Springs, Florida, pp. 49–53.

[278] Minutes of Evidence, p. 142.

The second issue was raised by the TAFE Commission, which cautioned that contract internal auditors generally did not allow ownership of their working papers and audit methodologies to transfer to their clients.[279] Although access to such work papers by the Auditor-General was not addressed, the Committee agrees that this situation is not in the best interests of an agency. If this situation has potential to arise, then the answer is obvious to the Committee—it is time for the agency to move on to another contract auditor or to establish its own in-house internal audit function. The CEO should ensure that the contract of engagement stipulates that work papers remain the property of and in the custody of the client agency if internal audit services are engaged on a contract basis.

AUDITOR-GENERAL'S INFLUENCE ON INTERNAL AUDIT

The Auditor-General admitted that "Our own quality reviews would indicate that we do not take enough heed of internal audit work."[280] On the other hand, Johnston expressed concerns about the Auditor-General requiring internal audit to focus more on financial audits than is warranted, resulting in reduced attention being able to be paid to operational areas of an agency.[281] This arises from the Auditor-General's external audit mandate to express an opinion on the financial statements, with some non-financial operational activities being immaterial to that opinion. The internal audit may, however, feel that real materiality from a total audit point of view lies within those non-financial operational areas.

The Department of Corrective Services provides an interesting illustration of this matter:

> If a clerk was to fraudulently appropriate say $15,000, there is every possibility that the normal controls within the Department would detect this and corrective action would follow. However, if a prisoner, say a murderer, rapist or child molester was freed prior to his or her correct release date, or by demonstrated incompetence allowed to escape, it is reasonable to expect that the Department would suffer considerable criticism in the media, with consequent political fallout.
>
> Internal Audit in Corrective Services examines such areas as Warrant recording, sentence calculation, policy affecting inmates, prison industries etc. These areas are of vital significance to the Department's management. The AGs do not ever venture into these areas.[282]

The Internal Audit Bureau also claimed that the Auditor-General relies so much on the work of the internal auditor (that is, the IAB), that the Auditor-General influences management so that the internal auditor is directed to carry out financial audits at the expense of more riskier non-financial reviews.[283]

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279 S8, p. 5.

280 Minutes of Evidence, p. 42.

281 S3, pp. 3-4.

282 S3, p. 4.

283 S9, p. 14.

Frankly, the Committee was surprised at these assertions. They indicate that a problem exists with the process of providing resources for internal audit. This report has already advocated that resources for internal audit should be provided on the basis of the audit plan, which has to be approved by the chief executive officer. Advice from the Auditor-General that additional attention should be placed on financial areas of an agency should be heeded, but this will obviously require a change to the audit plan and provision of additional resources accordingly. The Committee does not accept that there should necessarily be less attention paid to risky non-financial operational areas.

ACCESS TO EXTERNAL AUDIT PLAN

The Internal Audit Bureau alleged that when establishing the internal audit plan for the year, the Auditor-General rarely provides any details of the external audit plan for the year. The response to requests for that information is that the Auditor-General will review the internal audit plan and then decide what will be done by the external auditor. The Bureau pointed out that:

> Obviously it would be better if both plans were developed in consultation to avoid duplication.[284]

To be effective as they plan the total audit coverage of the agency, the internal and external auditors should develop and maintain close co-operation without compromising the mutual independence that is essential for the audit function.

Deloitte Ross Tohmatsu advised the Committee that:

> To prevent duplication of effort it is essential that internal audit has a close working relationship with other government agencies. This is most important in the relationship between the internal audit division and the Auditor-General. To enable the Auditor-General to place maximum reliance on the work performed by the internal audit division there should be opoen lines of communication between the two parties and at the very least there should be some input by the Auditor-General's staff during the development of the internal audit plan.[285]

This view is consistent with AUP10 on *Planning*, which requires the external auditor, when developing the overall audit plan, to consider a broad range of factors including:

- The degree of reliance he expects to be able to place on accounting systems and management controls including internal control

and

- The work of internal auditors.

[284] S9, p. 15.
[285] S11, p. 9.

The development of effective means of co-operation between internal audit and external audit is already established in s. 34 of the Public Finance and Audit Act:

> The Auditor-General shall audit the Public Accounts and such other accounts as the Auditor-General is authorised or required to audit in such manner as the Auditor-General thinks fit having regard to the *character and effectiveness of the relevant internal control* and *recognised professional standards and practices*. [emphasis added]

As stated earlier in this report, a strong and effective internal audit function is an essential component of the internal control system in an entity.

CONCLUSION

There will probably always be some tension between internal and external auditors, and between external auditors and their clients. However, the Committee considers that there is no need to make any further recommendations on these issues, as the solution to all of these concerns lies within the responsibility of audit committees and executive audit committees. This chapter has merely brought to light some problems that can occur in the absence of properly structured and functioning audit committees and executive audit committees.

The Committee would like to see one of the most significant outcomes of this report being the establishment of the primary role of audit committees and executive audit committees in the New South Wales public sector as *the bringing together and co-ordination of the functions of the Auditor-General (as external auditor), the internal audit, the management of an agency, and the board of management (if one exists) to benefit the whole agency.*

CONCLUSIONS

FINAL REMARKS

In his initial submission to the Committee for the inquiry into internal audit, the Auditor-General commented on risk management:

> It is difficult to bring to bear suggestions aimed at improving internal control when management in the 1990s are expected to be collective risk takers. The days of monumental internal control and check are gone. In their place we have risk management, which combines the ideal of internal control with an assessment of a shrewdly weighed risk factor. It is up to management to ensure that their assertions as to the increase of risk involved, and indeed allowed, in operating an entity are soundly based.
>
> Internal auditors can and should play a central role in the review of risk involved in operational management or financial systems and practices. . .
>
> Provided management risk and audit risk are properly assessed and subjected to rigours of internal and external audit review, accountability should thrive. In any case excessive risk taking elements in public sector management are subject to the spotlight of public reporting by organisations such as the Audit Office and ICAC.[286]

New South Wales has experienced considerable reforms in financial management in the public sector over the past decade. The introduction of risk management and the devolution of authority away from central agencies towards operational agencies, and down through those agencies themselves, have been major elements of those reforms. The Committee acknowledges the efficiency benefits to be gained from this management approach, but has some reservations about whether accountability is really "thriving" in all cases. After considering major losses in the private and public sectors of other jurisdictions in the 1980s, and evidence of more recent smaller scale problems in the New South Wales public sector, the Committee wonders whether the trend may have gone too far. The Committee senses that New South Wales may be on the cusp of a re-regulatory phase.

The Auditor-General was right in pointing out that the Audit Office and the ICAC play an important role in ensuring public accountability. So does the Ombudsman, but these agencies typically do not become involved until other agencies or projects run off the rails and public funds have been wasted, by which time it is too late. Internal audit on the other hand provides a more valuable preventative service, which in turn makes this report into internal audit by the Public Accounts Committee particularly good value for the New South Wales public sector.

The performance of the New South Wales public sector already compares very favourably with other States, particularly Victoria, South Australia and Western Australia, but that should not mean that we can become complacent. The Committee's statutory

[286] SO, p. 6.

responsibility as the watchdog on government expenditure requires us to ensure that we do not fall into the same traps as other States.

In this inquiry, the Committee has identified many significant issues in relation to the terms of reference, and has examined the issues in the context of the current environment of internal control and audit in the New South Wales public sector. The Committee has attempted to obtain current information on these issues as they relate to New South Wales and other jurisdictions. Rather than be discouraged by the Auditor-General's remarks that it may be difficult to improve internal control in an environment of risk management, the Committee has digested and considered all of this information to recommend changes to raise the profile of internal audit within our government agencies, which should in turn assist agency managers in maintaining and improving their internal controls.

However, the Committee was not in a position to make final specific recommendations on many issues in the limited time available for the inquiry, as well as the fact that many internal audit issues are still under consideration and development elsewhere. The Committee has instead identified issues such as audit committees and internal audit standards on which the NSW Treasury should devote resources for further research. The Committee has also recommended the establishment of an advisory group to assist the Treasury in that research, as well as ongoing review of the internal audit framework.

Looking firstly at factors outside an agency that impact on internal audit, the Committee considered whether the legal framework for internal control and audit was appropriate to address the accountability challenges of the 1990s. The Auditor-General stated in his first submission that:

> In my view those provisions are generally adequate to handle the accountability challenges of the 1990s. I say that because of the broad sweep of the Section.[287]

Of the NSW Treasury guidelines on internal audit, the Auditor-General expressed satisfaction that:

> The guidelines adequately outline the responsibilities of management in connection with internal audit.[288]

Other organisations which have a substantial internal audit function or are involved in conducting internal audit, however, suggested that the legal requirements for internal control and audit needed expansion, clarification and strengthening, and that the internal audit guidelines could be improved. The Committee has certainly taken that approach in this report, and many recommendations relate to amending legislation, and making the internal audit guidelines more useful to chief executive officers and line managers.

The Committee has learned much about the profession of internal auditing during the inquiry, and is impressed by the professional dedication generally shown by internal auditors. This is due to a large extent to sound professional standards for auditing, but the

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[287] SO, p. 2.

[288] ibid., p. 3.

Committee feels that these standards are not sufficiently recognised by non-internal auditors, particularly chief executive officers and senior line managers. The Committee believes that a uniform set of standards applicable to the public sector in Australia would be ideal, but realises that achievement of full co-operation between other jurisdictions may be difficult. The next best thing would be to follow the Commonwealth and develop our own set of standards, based on the those issued in America by The Institute of Internal Auditors Inc., but modified to our own needs and incorporating any useful features of other standards, e.g. those issued by the professional accounting bodies and Standards Australia. A group of appropriate people to advise the NSW Treasury on development and review of standards should provide impetus to this process.

Standards are a cornerstone of many issues in internal audit, but to be effective in raising the quality of internal audit, standards must be given appropriate backing. This should be done by issuing them as Treasurer's Directions, by making a specific legal requirement for compliance, and by establishing a system for monitoring compliance. This might involve broadening the scope of the Auditor-General's external audit function.

The Committee has found that legislation is often ignored (e.g. reporting relationships between internal audit and a chief executive officer). This indicates that legislation may not be the strongest form of control over government activities.

Instead, accountability of the government to the public through the Parliament can be strongly enhanced through the requirement for disclosure. Hence the Committee has made recommendations for information to be included in annual reports about internal audit, including the reporting relationships between in-house internal audit units and chief executive officers. The outcome of including a section on internal audit in the annual report is that the Parliament and the public can get some idea whether internal audit is effective in evaluating internal controls, or is being directed by the chief executive officer off into non-controversial areas.

The Committee acknowledges that the Police Service and the Department of Health, along with many other agencies, have made considerable achievements in establishing internal audit functions since the Public Finance and Audit Act was put in place. However, internal control problems in these two agencies amply illustrate that there is still considerable room for improving effectiveness of internal audit. The Committee has focussed the largest part of this report on the chief executive officer's responsibility for internal control and internal audit, as it is with the CEO and the CEO's senior line management that the greatest achievements can be made in raising internal audit's profile in government agencies. The inclusion in performance agreements of internal control as a key accountability of chief executive officers should help to emphasise this aspect.

Evidence given by officials of the NSW Treasury indicates that some may regard the Committee's recommendations as being re-regulatory in nature, but the Committee makes no apologies for this. As indicated above, this report may be the start of a new phase of management reform in which we back away slightly from the recent trend towards deregulation, devolution and risk management. The Committee believes that its emphasis on the CEO's responsibilities for internal control and audit is perfectly consistent with the concept of "letting the managers manage", but has the intention of ensuring that the managers do indeed manage.

Finally, a particularly strong point of this report is the recommendations for mandatory audit committees of boards of management and the encouragement of executive audit committees. Because of the special accountability relationships in the public sector between government agencies and their ministers, executive audit committees for agencies without boards of management are not an ideal solution, but certainly an approach well worth taking. The NSW Treasury will need to give much more thought on the role, functions and structures of audit committees and executive audit committees, as well as look for alternative mechanisms for government agencies without boards of management to ensure effective and efficient total audit coverage.

TERMS OF REFERENCE CHECKLIST

As this report is structured along lines that do not strictly follow the terms of reference, the following checklist is presented to assist readers in following up any specific matters in relation to the terms of reference.

The statutory requirement for and recognition of internal control and audit that are appropriate to address the accountability challenges of the 1990s

This is addressed in a general way in chapter 1, while numerous recommendations throughout the report are made to strengthen the legal backing for internal control and audit.

Management responsibilities for internal audit including internal audit charter, scope of audit coverage, and the mandate for internal audit to cover the main activities of an authority and subsidiary and controlled entities

Chapter 5 is devoted to management responsibilities of internal audit.

The reporting responsibilities of the internal audit

This is addressed under the heading *REPORTING RESULTS OF AUDIT* in chapter 7.

The relationship between internal audit and other agencies of government

This is the subject of chapter 2, while the special relationship between internal audit and the Auditor-General is presented in greater detail in chapter 8.

Quality assurance on internal audit

This issue is discussed in relation to both the agency management's and the internal audit's responsibilities for quality assurance. The former is discussed under the heading ASSURING QUALITY OF AUDIT in chapter 5, while the latter is covered under the same heading in chapter 7.

Appropriate management and board relations to the internal audit function, including the role and operation of audit committees

Chapter 6 is devoted to this term of reference

The competency and capacity of internal audit, including the minimum size necessary for an in-house function, the extent of competency of in-house internal audit, and appropriate arrangements for contracting the function

Competency of internal audit is treated under the heading of *ACCREDITATION AND TRAINING OF AUDITORS* in chapter 7. Discussion of the minimum feasible size of in-house internal audit units is presented under the subheading *Using in-house audit staff*, while contracting the function is covered under the subheading *Outsourcing internal audit*, both in chapter 5.

Any other matters relating to the improvement of internal control within agencies of government aimed at improving accountability

Chapter 3 on standards for internal audit, chapter 4 on management responsibilities for internal control, and *FINAL REMARKS* are relevant to this term of reference.

Review of the NSW Treasury's guidelines on internal audit

The role of NSW Treasury's internal audit guidelines is discussed under the heading of *ROLE OF INTERNAL AUDIT GUIDELINES* in chapter 3, while specific recommendations are made throughout the report for amendments that should be made to the guidelines.

Reference to the recent Commonwealth Auditor-General's report on results of a survey of internal audit in the Commonwealth public sector

Reference is made to this report under the subheading *Internal audit standards in the Commonwealth public sector* in chapter 3.

APPENDICES

APPENDIX 1: LIST OF SUBMISSIONS

No.	Date received	Name/position	Organisation
S0	5.12.92	A. C. Harris (Auditor-General)	Auditor-General's Office
S1	10.12.92	R. W. O'Connor	
S2	14.12.92	Allan Waldon	
S3	14.12.92	Geoff Johnston (Internal Auditor)	Department of Corrective Services
S4	14.12.92	Linda English	Department of Accounting, University of Sydney
S5	15.12.92		Ernst & Young
S6	16.12.92	B. C. Baylis	NSW Branch, The Institute of Internal Auditors—Australia
S7	21.12.92	James Guthrie (Senior Lecturer in Accounting) & Lynn Barkess (Lecturer in Accounting)	School of Accounting, The University of New South Wales
S8	21.12.92	Greg Woodburne (Acting Managing Director)	New South Wales Technical and Further Education Commission
S9	22.12.92	Percy Allan (Secretary, NSW Treasury) & W. Middleton (Director, Internal Audit Bureau)	Internal Audit Bureau of NSW
S10	4.1.93	R. E. Wilson (Managing Director)	Water Board
S11	13.1.93	Rory O'Connor (Senior Manager-in-Charge, Internal Audit support Services)	Deloitte Ross Tohmatsu
S12	14.1.93	Peter Forster	Ashley Forster, Chartered Accountant
S12A	22.2.93		Police Service
S13	2.3.93	T. Graham (Director of Audit), K. Sykes (Director of Audit) Dennis Taylor (Assistant Bursar, Systems & Operations Review and Audit)	GIO Australia Department of School Education The University of Sydney
S14	3.3.93	Stan Droder (Divisional Director)	New South Wales Division, Australian Society of Certified Practising Accountants
S15	4.3.93	A. C. Harris (Auditor-General)	Auditor-General's Office
S16	5.3.93	Mark Schlosser (Deputy General Manager)	Home Care Service of NSW
S17	5.3.93	R. Scullion (Chairman)	Internal Audit Bureau of NSW
S18	22.6.93	Thuy Mellor	NSW Treasury

APPENDIX 2: WITNESSES AT PUBLIC HEARINGS

Date	Name	Organisation	Page nos*
4.12.92	J. Holmes, B. Baylis & D. Byron	Institute of Internal Auditors—Australia	2–14
	I. Smith J. Spencer	Australian Society of Certified Practising Accountants Institute of Chartered Accountants	15–20
	D. Clements, S. Kemp, J. Eberhardt, K. Hawkins, R. Stanton & J. Gilroy	Department of Water Resources	21–35
	A. Harris, K. Fennell, G. Rowling & L. Slack	New South Wales Auditor-General's Office	36–45
	A. Clarke, B. Amos & K. Barker	Department of Health	46–57
22.2.93	J. Jarratt, L. Stirton, C. Brown, C. Cole & A. Abraham	New South Wales Police Service	58–67
	C. Gellatly & C. Ballantine	Department of Industrial Relations, Employment, Training and Further Education	68–75
	P. Wolfe & R. Balding	Roads and Traffic Authority	76–89
	A. Craswell	The University of Sydney	90–99
	K. Barker, B. Amos & A. Clarke	Department of Health	100–106•
	D. Marchant M. Schlosser	Department of Community Services Home Care Service of NSW	107–115
23.2.93	P. Roeleven, W. Middleton, R. Scullion & S. Vidovic	Internal Audit Bureau of NSW	118–130
	D. Fraser	University of Technology, Sydney	131–139
	A. Harris	New South Wales Auditor-General's Office	140–153
	P. Millington, J. Eberhardt, J. Gilroy & S. Kemp	Department of Water Resources	154–166
	K. Brown, K. Critchley & M. Krogh	Department of Sport, Recreation and Racing	167–177
	J. Kropp	Price Waterhouse	178–189
24.3.93	L. English	The University of Sydney	192–197
	P. Johnston & J. Elliott	State Sports Centre	198–203
	M. Jacobs & D. Worthy	Australian National Audit Office	204–214
10.6.93	M. T. Mellor & J. R. Chan-Sew	NSW Treasury	216–225
21.6.93	B. Fisk, R. Balding & A. Waldon	Roads & Traffic Authority	228–244

* Page numbers in the Minutes of Evidence, produced in a separate volume

• In camera evidence not publicly available

APPENDIX 3: SURVEY OF REFERENCES TO INTERNAL AUDIT IN ANNUAL REPORTS

METHOD

The annual reports for years ending in 1992 of 81 agencies listed in Schedules 2 and 3 of the Public Finance and Audit Act were reviewed. The main objective of the review was to assess whether internal audit was of sufficient importance to be included in the organisation charts of agencies or at least mentioned in the annual reports. A subsidiary objective was to determine reporting lines of internal audit, especially whether internal audit was responsible directly to the chief executive officer of an agency.

For each agency, the organisation chart and any accompanying explanation was examined. If internal audit was found to be shown on the chart, this was noted together with lines of reporting. If not, the remainder of the report was scanned to find any mention of internal audit or program evaluation, and any information about contracted-out internal audit services and reporting lines of in-house internal audit was noted. If no specific mention of internal audit could be found, this was noted.

It is possible that some cases where no apparent mention of internal audit or program evaluation was found could still include mention of internal audit, perhaps under another heading.

RESULTS

AGENCY	COMMENTS
Department of Agriculture	No apparent mention of internal audit.
Archives Authority	Results of program evaluation provided. Program evaluation and energy audit are contracted out.
Art Gallery	No apparent mention of internal audit.
Attorney General's Department	Corporate services mostly provided by the Department of Courts Administration, but no specific mention of internal audit.
Auditor-General's Office	Internal audit shown on organisation chart as directly responsible to the Auditor-General.
Australian Museum	No apparent mention of internal audit.
Broken Hill Water Board	Results of a partial program evaluation provided.
Building and Construction Industry Long Service Payments Corporation	Annual report combined with that for the NSW Superannuation Office. Organisation chart shows that Manager of Management Audit, comprising Audit Program, Program Evaluation and Fraud Risk Management, is directly responsible to the Director.
Building Services Corporation	Internal audit contracted out.
Cancer Council	Internal audit contracted to Ernst & Young.

Chief Secretary's Department	A fraud risk analysis was contracted to the Internal Audit Bureau, and program evaluations done both in-house and by the Internal Audit Bureau.
Coal and Oil Shale Mine Workers' Superannuation Tribunal	Internal audit carried out by the Management Audit Branch of the Building and Construction Industry Long Service Payments Corporation.
Coal Compensation Board	Internal audit provided by Internal Audit Bureau.
Commercial Services Group	Organisation chart shows Group Audit responsible to the General Manager of Commercial Services, who in turn is responsible to the Managing Director.
Department of Community Services	Principal Management Auditor shown on organisation chart to be directly responsible to Director-General.
Department of Conservation and Land Management	Section on the Management Audit Branch shows that the Branch is part of the Corporate Services Directorate, but lines of reporting are unclear.
Department of Corrective Services	Organisation chart shows the Director of Audit directly responsible to the Commissioner.
Dairy Corporation	Organisation chart shows that Internal Audit is directly responsible to the General Manager, although the position was vacant.
Darling Harbour Authority	Internal audit provided by Price Waterhouse.
Earth Exchange	No apparent mention of internal audit.
Ministry of Education and Youth Affairs	Results of 7 program evaluations presented.
Environment Protection Authority	No apparent mention of internal audit.
Film and Television Office	No apparent mention of internal audit.
Office of Financial Management (NSW Treasury)	Results of 3 program evaluations presented, but no apparent mention of internal audit which is conducted by the Internal Audit Bureau.
Fire Brigades	Organisation chart shows program evaluation to be a responsibility of the Director of Corporate Services, who in turn is responsible to the Director-General. Report includes a section on results of program evaluation. Financial statements show that the Internal Audit Bureau provides internal audit services.
Office of Fisheries	Internal audit contracted out to Internal Audit Bureau.
Fish Marketing Authority	No specific mention of internal audit, but Coopers & Lybrand are contracted to provide budgetary and financial advice, including review of the budget.
Forestry Commission	Mention of a Management Audit and Review Committee and of work of Management Audit and Review Staff, but reporting lines not shown.
Harness Racing Authority	Mention of one program evaluation. Financial statements show that internal audit is provided by KPMG Peat Marwick.
Department of Health	Director-General on organisation chart is shown to be directly responsible for audit.

Historic Houses Trust	Internal audit provided by Internal Audit Bureau.
Home Care Service	Internal audit contracted out to Coopers & Lybrand.
Department of Housing	Organisation chart shows Management Audit directly responsible to the Director.
Independent Commission Against Corruption	No apparent mention of internal audit.
Department of Industrial Relations, Employment, Training and Further Education	Internal Audit Unit and Planning and Review Unit are two of the three units of the Director-General's Office. Highlights and future priorities of these units are presented.
Legal Aid Commission	Internal audit is shown in the organisation chart as being a responsibility of the Assistant Director of the Management Division, who in turn is responsible to the Director.
Library Council	Mention of one program evaluation, but no apparent specific mention of internal audit.
Department of Local Government and Co-operatives	Organisation chart shows that audit is a responsibility of the Director of Operations, who is responsible to the Deputy Director-General, and then in turn to the Director-General.
Lord Howe Island Board	Mention of internal audit files only.
Maritime Services Board	The audit committee is mentioned, but no other apparent reference to internal audit.
Meat Industry Authority	No apparent mention of internal audit.
Department of Mineral Resources	Organisation chart shows that internal audit is a responsibility of the Director of Planning and Review, who is responsible to the Director-General.
Monaro Electricity	Financial statements show item for "An Auditing Firm for other Auditing services".
Motor Accidents Authority	Organisation chart and information on senior management indicate Management Audit as a responsibility of the Manager of Corporate Services, who in turn is responsible to the General Manager.
Motor Vehicle Repair Industry Council	Duesbury's provide internal audit services.
Museum of Applied Arts and Sciences	No apparent mention of internal audit.
National Parks and Wildlife Service	Organisation chart shows that Program & Performance Evaluation reports is a responsibility of the Manager of Corporate Services, who is responsible to the Director. A section on internal audit and program evaluation indicates that this is mainly conducted by Deloitte Ross Tohmatsu.
Pacific Power	Report includes a section on Corporate Internal Audit, but reporting lines are unclear.
Department of Planning	Section on internal audit indicates this is provided by the Internal Audit Bureau.

Police Service	Comprehensive Audit is shown on the organisation chart as a responsibility of the Assistant Commissioner for Professional Responsibility, who in turn is responsible to the Commissioner of Police.
Premier's Department	Management Audit Branch is shown on the organisational chart to be responsible to the Assistant Director-General, who in tun is responsible to the Director-General.
Property Services Group	No apparent mention of internal audit.
Prospect County Council	Organisation chart shows internal audit directly responsible to the General Manager.
Protective Commissioner	Internal audit services contracted out to Internal Audit Bureau.
Public Housing Authority	No apparent mention of internal audit.
Public Trustee	The organisation chart shows that internal audit is directly responsible to the Public Trustee.
Department of Public Works	Organisation chart shows internal audit directly responsible to the Director-General.
Rental Bond Board	The organisation chart shows a Systems Controller responsible to the Corporate Services Manager, in turn responsible to the General Manager.
Roads and Traffic Authority	Explanation of the organisation chart shows that General Managers of Operations Audit and Performance Evaluation are responsible to the Director of Finance and Performance Evaluation, who in turn is responsible to the Chief Executive.
Royal Botanic Gardens Sydney	No apparent mention of internal audit.
Rural Assistance Authority	The financial statements include an item for a fraud risk analysis by the Internal Audit Bureau, but no other specific mention of internal audit.
Department of School Education	Organisation chart shows Director of Audit directly responsible to the Director-General.
Department of Sport, Recreation and Racing	The organisation chart shows that program evaluation is a responsibility of the Matrix Manager, who is responsible to the Director, and internal audit is a responsibility of the Assistant Director of Administration, who is also responsible to the Director.
State Authorities Superannuation Board and State Superannuation Investment and Management Corporation	No apparent mention of internal audit.
State Emergency Service	Section on internal audit and control shows that internal audit services were contracted out to the Internal Audit Bureau.
State Transit Authority	The text of the annual report indicates that internal audit is a responsibility of the Corporate Finance and Administration Unit, but lines or reporting are not clear.
State Rail Authority	The organisation chart shows that the Internal Audit Manager is directly responsible to the Chief Executive.
State Sports Centre	Financial statements include an item for the Internal Audit Bureau, but no further specific mention of internal audit.

NSW Superannuation Office	Organisation chart shows that the Manager of Management Audit is responsible to the Deputy Secretary, who in turn is responsible to the Secretary.
Sydney Electricity	Organisation chart shows that the Internal Auditor is directly responsible to the Chief Executive, but he is also associated in some way with the General Manager of the Finance and Administration Division.
Sydney Market Authority	Organisation chart shows the Manager of Internal Audit primarily responsible to the Managing Director, but also responsible (shown by a dashed line) to the Secretary.
Sydney Opera House Trust	Organisation chart shows that the Internal Auditor is directly responsible to the General Manager.
Tertiary and Further Education Commission	Organisation chart shows that the Manager of Comprehensive Audit is responsible to the Manager of Corporate Services, who in turn is responsible to the Managing Director.
Totalisator Agency Board	Sections on internal audit and program evaluation, but reporting lines were not shown.
Tourism Commission	Organisation chart shows internal audit directly responsible to the General Manager.
Treasury Corporation	Mention of an audit committee, that Ernst & Young were contracted to provide specialist accounting advice, and that internal audit was contracted out, but no further specific mention of internal audit.
Water Board	Organisation chart shows internal audit directly responsible to the Managing Director.
Department of Water Resources	Organisation chart and explanation together indicate that internal audit reports to the Director, but reporting lines are not clear.
Waste Recycling and Processing Service	Passing mention of an audit committee, but otherwise no apparent mention of internal audit.
WorkCover Authority	Section on program evaluation, but no further specific mention of internal audit.
Zoological Parks Board	Section on audit and review within section on corporate services, but reporting lines not shown.

APPENDIX 4: SURVEY OF INTERNAL AUDIT IN AGENCIES

METHOD

A small selection of agencies was sent a letter asking for details of internal audit. The objectives of the survey were to gain an appreciation of resourcing, staff grading, staff qualifications, presence of audit committees, and other issues associated with internal audit in the New South Wales public sector. Agencies were informed that the specific results of the survey were to be kept confidential.

Information requested by the survey was as follows:

1. Salaries of the manager of internal audit and other internal audit staff
2. Total staff size and budget for internal audit
3. Internal audit functions contracted out
4. Professional qualifications of the manager of internal audit and other internal audit staff
5. Details of support given by management for ongoing training of internal audit staff
6. Internal audit charter, especially whether or not it contains a capability statement
7. Audit committee establishment and membership

The survey was targeted mainly at those agencies which have developed in-house internal audit functions. Twenty one agencies were surveyed, and all responded:

Department of Agriculture
Department of Conservation and Land Management
Department of Community Services
Department of Corrective Services
Dairy Corporation
Darling Harbour Authority
Forestry Commission
Department of Health
Hunter Water Board
Maritime Services Board
Pacific Power
Roads and Traffic Authority
Department of School Education
Department of Sport, Recreation and Racing
State Rail Authority
State Transit Authority
Sydney Electricity
Tertiary and Further Education Commission
Totalizator Agency Board
Water Board
Department of Water Resources

APPENDIX 5: LIST OF EXHIBITS TABLED IN HEARINGS

4.12.92 **INSTITUTE OF INTERNAL AUDITORS - AUSTRALIA**

1. Professional Internal Auditing Standards.
2. Codification of Standards for the Professional Practice of Internal Auditing.
3. 11A's 1992 Planner.
4. 11A's 40th Anniversary Magazine.
5. Leaders Guide.
6. "Newsaud". National Newsletter - September 1992
7. Annual Report 1991.
8. 11A's (South Pacific Region) Distribution List.
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