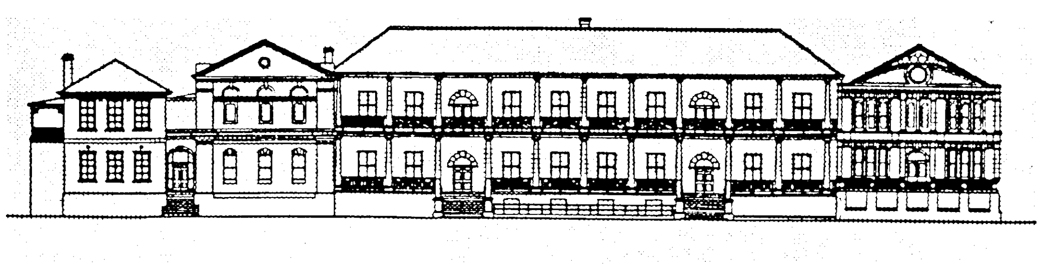
PUBLIC ACCOUNTS COMMITTEE

PARLIAMENT OF NEW SOUTH WALES

Proceedings of the 90th Anniversary Seminar on Internal Control and Audit

19 November 1992



Report No. 69 january 1993

PARLIAMENT OF NEW SOUTH WALES

PUBLIC ACCOUNTS COMMITTEE
OF THE
FIFTIETH PARLIAMENT

PROCEEDINGS OF THE 90TH ANNIVERSARY SEMINAR ON

INTERNAL CONTROL AND AUDIT

HELD ON 19 NOVEMBER 1992
AT
PARLIAMENT HOUSE SYDNEY

SIXTY-NINTH REPORT

January 1993

This publication has been catalogued in the New South Wales Parliamentary Library as follows:

New South Wales. Parliament. Public Accounts Committee. Ninetieth Anniversary Seminar on Internal Control and Audit (1993 : Sydney, N.S.W.)

Proceedings of the Ninetieth Anniversary Seminar on Internal Control and Audit, January 1993 / Public Accounts Committee, Parliament of New South Wales. -- [Sydney, N.S.W.] : Public Accounts Committee, 1993. -- 99 p. : 34 cm. (Sixty-ninth report / Public Accounts Committee)

ISBN 0731001613

1. Civil service -- New South Wales -- Auditing, Internal -- Congresses
I. Title
II. Series: New South Wales. Parliament. Public Accounts Committee. Report ; no. 69

351.0075 (DDC20)

Secretariat

Patricia Azarias, MPA *Princeton*, BA (Hons) *Oxon.*, BA (Hons)(Syd); Director

Ian Clarke, BSc *Syd.*, DipGeosc. *Macq.*;Senior Project Officer

Ian Thackeray, BSurv, BA; Clerk to the Committee

Caterina Sciara; Assistant Committee Officer

Wendy Terlecki; Assistant Committee Officer

Adviser

John Lynas, FCPA

Public Accounts Committee
Parliament House
Macquarie Street
Sydney NSW 2000

Telephone: (02) 230 2631
Facsimile: (02) 230 2831

From left:
Ray Chappell (Vice-Chairman), 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.

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.

CONTENTS

CHAIRMAN'S FOREWORD

The ninetieth anniversary of the Public Accounts Committee of the New South Wales Parliament is an important occasion in the development of public sector financial administration in the State. It is a time, not only to reflect on the achievements of the past, but also to consider the challenges of the future.

The 1990s, so far, can be described as the time when all businesses in Australia be they in the public or private sector are critically reviewing their performance in response to calls from stakeholders and regulators for a higher standard of corporate governance.

Members of boards and other governing bodies cannot individually oversee all the myriad of transactions that are the life blood of any modern business. To be effective, management must introduce and maintain a system of internal control to cover all the financial and related aspects of the business. A system of internal audit should be in place to report independently to top management that all the internal accounting and related controls are working as planned.

The public sector in the 1990s is not immune from these demands. In other jurisdictions breakdowns in internal controls have resulted in major losses in government owned enterprises being underwritten by the ordinary taxpayers.

This seminar, hosted by the Public Accounts Committee to mark its 90th year, fulfils a vital need. It is now appropriate for the whole question of internal control and audit to be subject to critical review.

A panel of leading experts was brought together to focus the interest of nearly 200 internal audit practitioners and educators.

Mr Ian Temby, QC, the Independent Commissioner Against Corruption has been along time proponent of internal audit. In his investigation into allegations of corruption Mr Temby has found evidence that ineffective or inefficient internal audit can indeed be a catalyst for corruption.

Sir Harold Knight, retired Governor of the Reserve Bank, shared his experiences of the importance of internal audit from the perspective of the Chairman of boards of Directors of large business operations in both the public and private sectors.

Mr Jim Kropp, a senior partner with Price Waterhouse, has wide ranging experience in internal audit in both the public and private sectors. Mr Kropp spoke on the need for an independent approach by internal audit and the need for the external auditor to also address the issue of independence.

Mr Tony Harris the New South Wales Auditor General, spoke on the role of internal auditors as allies of the external auditors. The total audit coverage in any organisation can only be enhanced if effective co-operation and collaboration is achieved between external and internal auditors.

Mr Paddy McGuinness gave a refreshing overview from the perspective of a journalist trained as an economist who has had wide experience both in Australia and overseas.

The seminar was an outstanding success. This was evidenced not only by the full house on the day but also by the positive response from many of the participants afterwards.

In conclusion I would like to acknowledge the support of the Minister for Finance and Assistant Treasurer, the Honourable George Souris, M.P. a former vice-chairman of the PAC for formally referring this important topic to the committee.

To my fellow committee members I acknowledge their support and encouragement in addressing this important issue in a bi-partisan manner which is typical of the PAC.

Finally, I acknowledge the staff of the PAC, especially John Lynas, for organising the Seminar, Wendy Terlecki and Carole Worland for providing secretarial assistance and Jozef Imrich for taking the photographs.

Andrew Tink MP
Chairman

Parliament of New South Wales

PUBLIC ACCOUNTS COMMITTEE — 90th ANNIVERSARY

SEMINAR ON INTERNAL CONTROL AND AUDIT

Thursday, 19th November, 1992.

TRANSCRIPT OF ADDRESSES

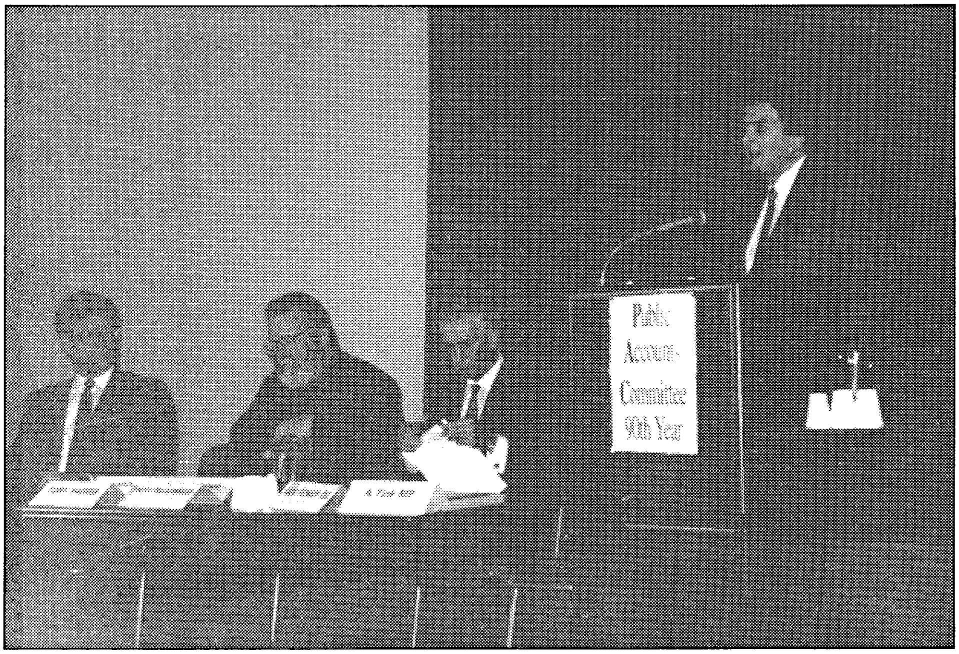
SEMINAR ON INTERNAL CONTROL AND AUDIT

19 NOVEMBER 1992

PARLIAMENT HOUSE SYDNEY

OPENING ADDRESS

MR A TINK MP, CHAIRMAN
NEW SOUTH WALES PUBLIC ACCOUNTS COMMITTEE



Mr A Tink MP, Chairman

OFFICIAL OPENING

Mr Andrew Tink, MP, Chairman, Public Accounts Committee

I welcome you to the Public Accounts Committee's 90th Anniversary Seminar on internal control and audit. The Committee met a few weeks ago to consider how best to celebrate its 90th Anniversary, and we decided that given our particular charter, it might be most constructive for us to put on a Seminar to promote some public interest in a key issue. We chose Internal Control and Audit, because we got a reference from the Minister for Finance, the Hon. George Souris, to look at that topic, and because it became plain to us when we put notice of the seminar about, that there was extraordinary public interest in a topic of this nature.

I suppose it is not hard to understand why, when you read the papers at any time over the past six months, and see the common threads that are emerging in Royal Commissions that unfortunately seem to be taking place all over Australia. I think it is fair to say that to a very significant extent a lot of what is occurring and what has been brought up in those Royal Commissions is as a result of a failure of internal control and/or internal audit.
I have been a member of a couple of councils now for a few years, and it has been of on-going interest to keep up for myself the question, in a pro-active sense, 'What are my roles and responsibilities? To what extent should I be questioning chief executive officers? How far should I go in testing propositions that they put up, hopefully not cross-examining, but certainly probing very actively the sorts of matters that are put up by way of reporting and so forth.'

It seems to me that that is a very relevant issue that we have for consideration today, and one of our key areas I suppose is to look at the role of directors. I use the word 'directors' in a general sense. I suppose it has a specific corporate sense, but I use it in the more general sense of describing anybody who has a broad or over-riding responsibility in relation to an organisation.

Those roles can be as significant as an involvement in a very big government trading enterprise, down perhaps to middle-ranking organisations such as one I am involved in, Macquarie University, which is getting closer and closer to a $100 million business per annum, and moving right on down to the local tennis club. That was an example that I think the former Deputy Treasury Secretary gave here a year or so ago (Don Nicholls, now the head of Treasury in Victoria), to illustrate that even at that level there are significant responsibilities. Indeed with the Department of Sport and Recreation grants and so forth that are now being given in significant dollar terms to even small clubs, there is great concern I think and great responsibility even on people who are on the boards of tennis clubs or soccer clubs or even a local scout association.

The other aspect — and it goes hand in hand — relates to the question of internal audit and that again has been a very significant issue right around the country, and it has been significant in New South Wales and obviously will remain so. We are very pleased to have here the Commissioner of the Independent Commission against Corruption to talk on that topic. As most of you will be aware, there has been a significant report from the ICAC dealing with that issue, and I think that more than passing reference has been made to it on other occasions.

I suppose at the end of the day everybody has a pro-active responsibility to get out and question and to seek information to make sure that things are working properly and as they should, and as with everything else, it is a question of finding the right balance. Obviously you do not want internal auditors or boards of directors involving themselves to a point where the plot is lost and their activity becomes counter-productive to the goals of the organisation, and there has to be that balance in the system.

Can I remind everybody that this is a Parliamentary sitting day. We make no apology for that, because I think it is important on a working day such as this to have a group of you in, and also to involve my Parliamentary colleagues in this process. What it does mean is that from time to time bells may ring and buzzers may go off and some of us may be in some haste to get to a division. There might be one in about an hour or so. It should not affect the proceedings.

Without further ado I would like to ask Mr Ian Temby to make a presentation to you. I do not think Mr Temby needs much of an introduction, although it is important to highlight a couple of positions he has held. He has been President of the Law Council of Australia. He has also been the first Director of Public Prosecutions of the Commonwealth, and he is the first Commissioner of the Independent Commission against Corruption in New South Wales. I now ask Mr Temby to address us.

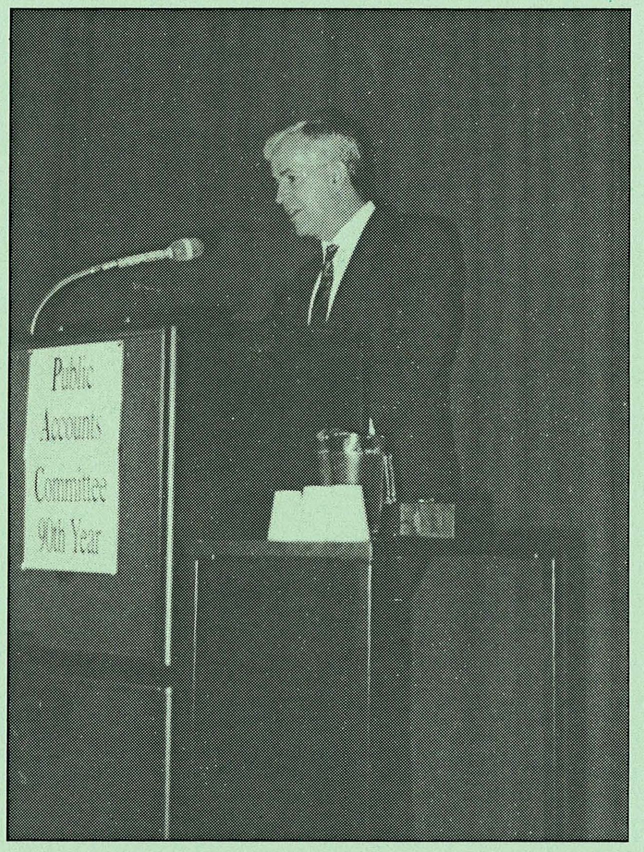
SEMINAR ON INTERNAL CONTROL AND AUDIT

19 NOVEMBER 1992

PARLIAMENT HOUSE SYDNEY

INCOMPETENT INTERNAL AUDIT: A CATALYST FOR CORRUPTION

MR IAN TEMBY QC
INDEPENDENT COMMISSIONER AGAINST CORRUPTION



Mr Ian Temby QC, Independent Commissioner Against Corruption

INCOMPETENT INTERNAL AUDIT
A CATALYST FOR CORRUPTION

Mr Ian Temby QC, Independent Commissioner Against Corruption

Ladies and gentlemen, let me start by emphasising some positives. We are here today to talk about internal audit in the public sector of New South Wales. However, it should not be thought that the problems which internal audit addresses, are confined to that sector. Indeed, as at today there is some reason to believe that in this country controls in the public sector are tighter and more effective than they are among some of Australia's great companies, for example the private banks. So it is not just a public sector problem area which is being addressed.

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, and you will not have missed the fact that this is the 90th Anniversary of the Public Accounts Committee in New South Wales. There are some States that could not hold a first anniversary party.

Finally by way of preliminary, it should be stated that the topic we are addressing today is accorded importance among all developed nations. There is universal recognition that an effective internal audit system is essential, that external audit will not suffice. There is universal recognition that audit, whether internal or external, must go beyond the merely financial and also examine systems, the use of resources, and attainment of the organisation's objectives in a cost-effective fashion. The ICAC is concerned with internal audit, because for clear reasons effective internal audit will reduce the need for us to become involved in the affairs of any particular organisation, and we have had something to say about the topic.

However, I must emphasise that I do not pretend to be personally an expert in this area. You will be hearing from appropriate experts later in the day, and I shall be addressing my remarks at a fairly general level. It must be enormously encouraging for the organisers of this seminar that it is so well attended, and there is such a lot of interest in this important topic.

So far as internal audit is concerned, what are the essential requirements if it is to be effective? I suggest that they can be reduced to four.

The first is that independence is indispensable, as is a robust approach. Independence must never be confused with autonomy. Those responsible for internal audit must have a charter, so it is known by them and within the organisation generally, because the charter should be widely promulgated, where their responsibility starts and where it stops.

The charter should not be narrow in its scope. Conflicts of interest must be avoided, whether actual or perceived. This applies to the positioning of the section in the organisation as well as it does to the activities of the organisation. Accordingly audit staff should remain as such for a decent period, a couple of years or three or four years, and it is important they are not diverted to special projects or given responsibility for operational matters. People should not dance into and out of internal audit as seems sensible according to the whim of the CEO.

For similar reasons the opinion of the internal audit should be sought on major changes to systems and procedures, but internal audit should not design them. For that to happen, the capacity for creative criticism would be compromised at least, and lost at worst.

Second, 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.

There must be adequate resources provided for staff training and professional development, and staffing and remuneration must be commensurate with the size and complexity of the organisation and a realistic assessment of potential risk.

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.

Third, and this is critically important, auditors must help, not hinder. Internal auditors must work within and for the organisation. It is not for them to throw up artificial barriers or concentrate upon procedures to the detriment of effective outcomes. They must look for systems improvement. Where an audit discloses deficiencies there must be recommendations made for change. They must not simply criticise, but rather indicate how the problem can be fixed. Those recommendations must be realistic and cost-effective, and should be developed in consultation with line management.

Audit plans must ensure a level and frequency of examination of major systems in keeping with materiality. Audit reports must be accessible, which means that the level of detail should be appropriate to the intended audience, and jargon should be avoided. Internal auditors, like any other specialists, must avoid the use of abstract language which is incapable of comprehension generally in the organisation.

Those who perform internal audit functions should always work with and not against the agency head and line managers.

Fourth, and again this is critically important, it has to be recognised that internal audit is not enough. To be effective, internal audit must have the total support of the chief executive, but even a well-managed and well-resourced organisation responsible for internal audit cannot be everywhere at once, and is not a substitute for good management practices. Senior management must be actively involved. Managers and supervisors are still responsible for telling staff what is expected of them and ensuring that review and appraisal systems are in place. They cannot be allowed to say 'We have an internal audit section; it is their responsibility and will just get on with making a dollar or putting out more gismos', if it is Gismo Incorporated we are looking at. They have to take the prime responsibility for ensuring efficiency and integrity, and internal audit must be looked upon as being a complementary resource. In roughly the same sort of way, if you look at the New South

Wales public sector as a whole, it is for chief executives and top managers to take responsibility for instilling a sense of purpose and integrity within the organisation, and a body such as the ICAC or the Auditor-General comes along and fills in such gaps as may be found. But you cannot devolve responsibility for achievement of these critically important objectives to such organisations. They can play a part, but they can only play a part. You cannot leave the problem of corruption to the ICAC. It has to be tackled right across the board.

The next question is, What happens when internal audit is non-existent, poorly resourced, or otherwise ineffective? If that is the case, then it is a sure sign of an organisation that does not care about efficiency and integrity, and such signs are always recognised by staff. Incompetent internal audit is undoubtedly conducive to corrupt practices, and it will tend to have one or more of the following characteristics.

Internal audit will fail if the working assumption is that nothing much can go wrong within the organisation. We have seen examples of that in the work we have done. For example, our quite short report into Maritime Services Board and the provision of helicopter services to that Board demonstrated a case in which the internal audit function failed because of what appeared to be a somewhat indifferent approach to the performance of functions by the individuals within the section, because of, if you like, an insufficiently robust approach. They had a quick look at the particular problem area, prepared a cursory report that said there was nothing to be concerned about, and the result was that the problem was not just not tackled, but it was continued and the same sort of problems that had been encountered in year one were encountered in even worse form in year two.

If the approach taken is not sufficiently sceptical and robust, if the working assumption is that everything is all right, then that is a sure sign of incompetent internal audit and it is of course conducive to corruption as was demonstrated in that particular report.

A sign of incompetent internal audit is a tendency to become involved with running checks and investigations only when something goes wrong. It is essential that the internal auditors should also be looking at systems concerning which there is no present apparent concern, because the fact that nothing nasty has come to the surface is by no means an assurance that all is well. The internal audit must be looking at the bits of the system that appear to be running well, as well as at those that seem to have failed, in order to be effective.

It is also essential that the internal auditors should be looking at systems improvement and education. If they are not doing that, if there are deficiencies in those respects, you then have the *indicia* of ineffective internal audit which is bound to lead to continuing and increasing difficulties.

I next want to say something briefly about what one needs so far as effective reporting mechanisms are concerned. 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.

In order to achieve that, it is important that there should be a system whereby, whenever practical, confidentiality is accorded to those who bring such matters to attention, and that their willingness to do so is applauded rather than visited with negative consequences. There must be a channel whereby when necessary that can be done to the top, because there is always the possibility that internal audit itself will go bad. There must be a capacity for individuals in an organisation to bring such matters to the attention of the chief executive, or some other person at top level but preferably the chief executive, just as it is essential that internal audit should have access direct to the chief executive and not be required to go through bureaucratic layers.

As soon as those who are concerned about things which they think are wrong with the organisation must go through two or three levels before their concerns can be heard, then they will be greatly discouraged from bringing matters to attention and that is, for obvious reasons, highly undesirable.

It is next essential that when matters are brought to attention in this way, there should be feedback to those who are concerned, and if the concerns are justified, it must be obvious that action is being taken. Accordingly feedback and action are critically important. If complaints are seen to go into black holes, and what happens in consequence never comes out at the other end, that has an enormously discouraging effect upon the individual concerned, and is likely to have such an effect by extension so far as work colleagues are concerned.

Self-evidently it is essential that those who bring matters to attention should not be victimised. We all know that victimisation may be flagrant but is far more frequently covert, insidious, and simply discouraging. Again an essential element is that of continuing education so as to achieve the sort of attitudinal change which is always necessary to be achieved.

Finally, ladies and gentlemen, could I say and indeed stress that all of this must be considered as part of a greater whole. The aim of top management of any organisation should be an organisation which is charged with a sense of purpose and integrity. If that is to be achieved it must come from the top. What might be described as climate, or if you like manifest attitude, is critically important, and I suggest that the proper approach is to acknowledge and articulate the fact that in fairness to staff they should be given a chance to work in a properly ethical environment.

Given that chance, it is clear that they will take it. People want to work in an organisation which has a sense of purpose, which is efficient, in which they feel they are making a positive contribution, and in which proper values prevail. Given a chance they will always opt towards those things and tend to turn their backs upon the corresponding negatives. So, given the chance to work in an ethical environment, people will take it, and the responsibility of top management is to give them that chance.

Internal audit can and will play a part, but everybody shares in the responsibility of giving staff that opportunity. Accordingly internal audit is important but in and by itself it can achieve almost nothing. It has to be a component part of a whole.

DISCUSSION

The lack of protection for whistle-blowers is I think one of the greatest problems. If he comes to a point where he feels he cannot go anywhere, the question is whether there is anything in the pipeline to your knowledge by which greater protection can be given? Usually what happens is that the auditor loses his job, he faces going outside the organisation, loses his career, and loses the support for his family.

Mr Temby:

Some legislative measures are under contemplation. As memory serves me, a paper has been put out I think by the Cabinet Office, and it was the subject of discussion I know at a seminar held at the University in the order of a couple of months ago. The ICAC was one of the organisations whose representative spoke at that seminar, and I am sure that the material that was there discussed would be of interest to you and to many others in the audience, and it could easily be provided. I do not know whether the papers have been published, but obviously they are available.

It is a topic with which the Commission is very much concerned, but I do not pretend to be on top of the debate at this moment. Accordingly I will be making only some general comments.

The first is that in an organisation that cares about its staff and cares about integrity issues, there will be internal reporting mechanisms of the sort that I touched upon, which will render it unnecessary for a concerned staff member to go outside. It ought to be the case that you design a system and encourage your staff to implement that system so that problems are addressed in a timely fashion internally. That ought to be the aim, and any manager should see it as being a sign of failure if there is a need to go outside.

However, there is sometimes that need, and again if I can talk about the public sector as a whole rather than individual organisations at the moment, the ICAC is clearly an organisation which does from time to time receive information from individuals within organisations.

Strictly speaking, there should not be such a need. Organisations should have effective reporting mechanisms which ensure that the executive is aware if things are going wrong, and under section 11 of our Act the chief executive is obliged in those circumstances to tell us, so that we can decide whether it is a matter that we should take on, or whether we should extend courteous thanks for the advice and pass it on or back to the organisation, which we often do, to address for themselves.

Sometimes those circumstances do not prevail, and sometimes individuals do come to us, and naturally we do not show them the door. We are bound to listen. If any person who made an approach to us was in consequence of that approach victimised, we would be vastly unamused. We would do what we could to provide sensible protection for the individual.

I suppose the third comment that needs to be made in a realistic way is that so-called whistle blowers are not always right; they are often wrong. They are frequently difficult prickly individuals who need to be treated with scrupulous care. I see that the gentleman who addressed the question is nodding and knows what I am talking about. It is too easy, and it is cheap, to say that whistle-blowers are modern-day saints. They are not. They are often wrong, and when that is the case they need to be told so. They are often right but difficult, and when that is the case, the difficulty, the prickliness, which often stems the fact that they have been ignored over the years, needs to be put to one side and the concerns they bring to the surface need to be addressed.

That is only a fairly discursive response. There is work being done in this area, and I would encourage you and others to acquaint themselves with what is happening, because it is a very important area. Our position is that the solutions which are now on offer, while they represent an advance, do not go far enough, and more should be done than that which is at present in place.

Mr Ted Lesh:

I am the Secretary of the Institute of Internal Auditors. Most of the attributes that you look for in a well-run internal audit unit are covered by our professional standards. I believe there is a move in the Commonwealth government to give

some sort of backing to these standards. Is there a similar move in New South Wales?

Mr Temby:

There is not, so far as I am aware. I am aware of statutory requirements contained in section 11 (2) of the Public Finance and Audit Act, and I am aware of Treasury Guidelines, and for what it might be worth, and we wish to stress that we are not professional experts in this area, there has been ICAC discussion of internal audit which effectively formed the middle part of my address this morning, contained in a report we put out a year or so ago on the Roads and Traffic Authority and driver licensing. What we had there to say by way of encouragement will be of interest to many, and those reports are available.

The combination of a statute and the Treasury guidelines provides a good deal of stipulation. In a sense, as I understand it, this seminar is an early part of a process of examination by the Public Accounts Committee of what changes are called for. I imagine those changes would be by way of buttressing current standards rather than by way of diminution of them. The Chairman nods. So we are likely to see more not less, and I am sure that an organisation such as the one that you head will be called upon to make a contribution to the process.

Let it be said, however, that in stipulating with greater clarity the requirements that are to be met so far as internal audit is concerned, we must not fall into the trap of assuming that that involves ever-increasing layers of bureaucracy, and concentration upon process, rather than outcomes. That would be a deathly result which has to be avoided, and it can be avoided. A really interesting thing is that in the systems improvement work which the ICAC does, which we call corruption prevention, which involves going out to departments and agencies and looking at particular systems and working with people to devise improvements, we have found with practically no exceptions, that you can tighten systems and improve systems, while at the same time simplifying them and improving the efficiency of the organisation.

Our experience has been, with practically no exceptions, that you can improve systems from the viewpoint of reducing corruption opportunities, while at the same time improving their efficiency. You do not have to pay a great price in terms of reduced efficiency in order to reduce corruption opportunities. That, I suggest, is very good news, because obviously you cannot afford a public sector which is constantly concerned with procedures rather than outcomes. That is to talk about the public sector as it was years ago — or so I am told, though we might be told lies about it. We are told it used to be the case that keeping the files in order was the real mark of the success of the bureaucrat of a bygone age, and there was not enough concentration upon outcomes. To the extent it was true, that is clearly undesirable. Our experience is that you can improve efficiency at the same time as improving integrity and reducing corruption opportunities.

Mr TINK:

I would like to thank Mr Temby very much for his presentation. I think he set the scene very well for the remainder of the day. I know he has a busy schedule back at the ICAC with the police inquiry, so without further ado I thank him very much for coming along this morning.

Before proceeding to introduce the next guest, I would like to introduce my Committee. From left to right as you see them they are: Geoff Irwin, Member for Fairfield; Ray Chappell, my deputy chairman, who is Member for the Northern Tablelands; Terry Rumble, Member for Illawarra; and Ian Glachan, Member for Albury.

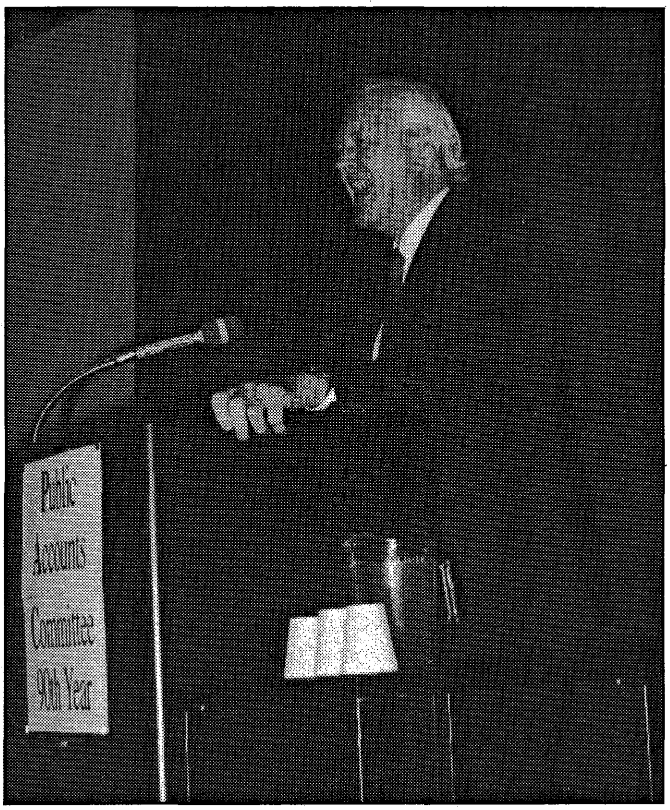
SEMINAR ON INTERNAL CONTROL AND AUDIT

19 NOVEMBER 1992

PARLIAMENT HOUSE SYDNEY

FROM THE SMALLEST TENNIS CLUB TO THE LARGEST GTE
HOW DEEP SHOULD DIRECTORS DELVE?

SIR HAROLD KNIGHT
FORMER GOVERNOR OF THE RESERVE BANK OF AUSTRALIA



Sir Harold Knight, former Governor of the Reserve Bank of Australia

FROM THE SMALLEST TENNIS CLUB TO THE LARGEST GTE; HOW DEEP SHOULD DIRECTORS DELVE?

Mr TINK: It is now a great pleasure to introduce Sir Harold Knight, who is to speak on the next topic. To my mind it is one of the key issues that have arisen in the sorts of Royal Commission reports that we have been reading so much about in the past few weeks.

Sir Harold is a director of Western Mining Corporation, he is a member of the Council of Macquarie University, a member of the New South Wales Police Board, and between 1975 and 1982 was the Governor and Chairman of the Reserve Bank of Australia. In addition to that he has held a number of other influential positions over the years, and the Committee feels that he is exceptionally well placed to talk on this topic. Without further ado, I would like you to welcome Sir Harold Knight, please.

Sir Harold Knight, former Governor of the Reserve Bank of Australia:

Thank you, Mr Chairman. I congratulate you on attaining the age of 90. You are a very youthful looking nonagenarian. I would like to wish you a very successful future, and I compliment you on the way you have chosen to run the celebration. It is frugal and professional and very attractive. We have a very interesting panel of speakers. They know a lot about the New South Wales government and I do not, so I have to come at this with a rather stand-back, general kind of approach.

When I was in the army I had a fair bit of input on methods of instruction, and the one I liked best is the one that describes how the British sergeant-major teaches his troops. He says 'First, you tells 'em what you are going to tell 'em, then you tells 'em, and then you tells 'em what you told 'em'. I am proposing to follow the first two of those steps this morning.

I will tell you what I am going to tell 'em. I would like first of all to move the status of professional financial control right to the centre of the stage as being vital to the welfare of Australia, and I would like to tell you a bit of a story that points that up.

Second, I would like to talk to you about how a non-executive director in private enterprise can confront the fiduciary duties he owes to a wide range of people. It is an awesome kind of thing to have to do. Over the past ten years I have done a fair bit of it, and I would like to share with you from that laid-back stand-back-ten-paces viewpoint how it feels and how you go about it.

Third, I would like to suggest that some of those lessons from experience translate across into the government sector without getting into ICAC and Auditor-General territory, which territory I am not professionally equipped to talk about.

In a developed country such as Australia, the overwhelming majority of people experience a level of wealth - of the availability of goods and services - that far exceeds the standard of living of most of the people of a hundred years ago. In the European countries that increase in wealth from the harsh conditions of the peasant subsistence economies began something like 250 years ago and has run fairly strongly since. The development has been, as our TV sets tell us, uneven between country and country, and has not taken hold in some countries. It has been very uneven between continent and continent. In our country, that developmental progress has gone reasonably well — although we could do better if we managed our affairs more sensibly. Let me ask two questions: What are the factors that have made us prosperous? and What contribution has our theme of today made to our prosperity?

The main factors in our prosperity seem to me to be two obvious ones, and one not so obvious. First of all we must acknowledge our magnificent natural resources - land, water, climate and minerals. We are very rich compared with our small population. Second, there is our workforce - Australians like to knock themselves, but the fact is that we have a workforce that is healthy, reasonably hard-working if well led, and the product of a pretty good universal education system. It is a good workforce. Those are factors that contribute primarily to our wealth.

The third factor is our method of production. We can think of it as an indirect, or roundabout, system of production. Typically, a businessman identifies a demand for a particular product. He plans a unit to produce that product, and he will plan to get it to its market. The essentials of his business are raw materials, a work force, and capital. The capital is needed to set up the workplace, to buy in the raw materials, to pay the workforce while they are making the product, and he has to tide over the extra waiting period from when the product goes off to market, and when the sales proceeds come back again. A lot of capital is needed for a middle-sized industrial venture.

Where production is done in this way, it can be extraordinarily efficient at getting wanted goods to the point of sale at very attractive prices. The old cottage industry from 200-odd years ago had no hope of doing as efficient a job. But as well as having the materials and the labour, the businessman must be able to get hold of capital - money - on a substantial scale; mostly well beyond his personal wealth.

It so happened that a while back I spent a few years working on economic aspects of many of the twenty-odd republics of Latin America. A striking fact was the absence of a thriving manufacturing sector, middle-size and larger, such as we take for granted. I thought quite a bit about why this was so. Raw materials and a labour force existed, but they were not being used as they are used in our country. As I talked with my friends and business associates, one factor of difference became obvious.

In our country, for the most part, the entrepreneur is an honest man. He explains to others — in a prospectus, or in a loan application — what is his business plan. He says what he intends to do with money that is entrusted to him by others. And the expectation is that he will put the money to the use he says he will make of it. Over the many decades — and notably recently — there have been conspicuous exceptions to this general rule; but they are exceptions. The general standard of commercial morality in Australia — and the aberrations are exceptions — is such that most businesses are able to obtain and use, to finance a good part of their business, other people's money.

In Latin America, as I chatted and inquired it became clear that the standard of business morality was not like this. If one handed money to someone else for a specified business use, the probability that it would finish up elsewhere, and not be repaid, was very much higher than we are accustomed to. As a result, it was extremely difficult for an individual in Latin America to set up large-scale production facilities in the private sector. I finished up thinking that the rather backward state of the productive sector in many of those countries stemmed to a considerable extent from that fact of a rather lower level of commercial morality.

All that is a rather roundabout way of saying that our prosperity depends to a considerable extent on the willingness of investors to fund substantial business enterprises. Two matters are involved here: one is our general level of commercial morality, something we cannot influence, which I judge to be reasonably high — the exceptions always being noted: the great Australian con man is famous.

The other point is the adequacy of our arrangements for keeping it so — which is, of course, our subject for today.

From what I have just said about the importance of the availability of capital for business, you will gather that I have a high view of the value of the work of those in the private sector and also in government who look after these matters. As well as their other motivations, those folk should take into account that working hard at ensuring that resources in private business are used in an upright way and properly is a vocation which contributes in a vital way to the well-being of all Australians. I would encourage our private sector financial folk to see themselves as having a first-class vocation. They are not just bean-counters; they are vital to our prosperity.

Similar benefits flow from the maintenance of high professional financial standards in government administration. This seminar has been convened by our venerable Parliamentary Accounts Committee to enhance the quality of internal control and audit within the New South Wales government sector. Something like a quarter of all spending in Australia flows through government hands. There is clearly need and scope for the application of the best of professionalism in the management of those flows. I have been conscious of the effects of the strong attention that has been given, over quite some years past, to the improvement of the quality of financial work throughout this State's government. I would like to encourage those who have this work in hand to see it as a high vocation, contributing substantially to the wellbeing of the people of this State.

Let me turn now to my second part: How deep should directors delve? I shall talk about that insofar as it relates to my experience in the private sector. During the past ten years I have served as a director, and in two instances as chairman, of a number of boards of companies in the private sector. What can I say in answer to that question - How deep should directors delve?

I am going to set aside the question of systems and take them pretty much for granted. We have excellent systems, so I shall set aside the formalities and get to the real question as to how a director can confront his responsibilities. It is not easy for a non-executive director. At one level, there is need for compliance with legal requirements. The ordinary person — by which I mean one who is not legally trained — is not in a good position to ensure at first hand that his company is detail-perfect in its compliance with requirements of statutes and codes. If a non-executive director seeks to be a full-bottle expert in that area he has his work cut out. He has to do it differently: he is in the hands of professionals.

Of course there is the benefit of wide reading to maintain awareness in general of changing requirements, but basically the safeguard for the non-legal director is the quality of the professionals — the company secretaries, the accountants, the auditors — who carry primary responsibility for compliance. The non-legal director has a duty to assess the competence and integrity of his team, he is part-time and he has difficulty in reaching them, but he has to do it. He has to keep talking to them with the aim of being satisfied that they are adequate in quality, and alert to the needs of their job.

The duty of a director has a kind of a peak period in it once a year. There is a meeting and at that meeting he is required to vote on acceptance of the annual accounts, or even to sign them. That crisis is best surmounted, if it is not taken as a one-hour stint once a year, by a consistent course of action throughout the whole year.

We should pause and think about the variety of stakeholders to whom the director is accountable. The director has obligations to a variety of stakeholders in the business -

chiefly to the proprietors, to the workforce of the company, to the suppliers, to the financiers, and also to the customers. These days they are extending the list. If you get into the business of polluting the environment, as a director you are inclined to go to gaol. So you have a wide range of accountabilities.

Setting aside the formal compliance with statutes and codes, his job is to see that - so far as he is able - each of the many stakeholders gets a fair go.

Many boards have responded to these pressures from these various groups by deputing some of their concerns to an audit committee. That is a useful device, but it is only a device. The audit committee is made up of some non-executive directors. When the annual accounts are presented to the board at that meeting for adoption, the chairman of the audit committee has the opportunity to explain what steps he and his colleagues have taken to satisfy themselves that the accounts are proper for the board to adopt. Helpful as this procedure can be, the onus still rests with the individual director; has he personally taken all reasonable steps to ensure that all is well? He has to look behind him and see that wide range of stakeholders to whom he is accountable by his holding office as director and in saying that all is well.

Without traversing the material you will find in the excellent publications of the many institutes in this field, there are two approaches to these matters that may be mentioned.

One is the question of what appointment a non-executive director should accept. With the best will in the world, and with every effort made, if there is a lack of integrity in the organisation of which one is part, there can be no confidence that we can, in effect, say to the stakeholders that all is well.

At one stage, there was the thought of my being appointed to a particular board. Without being very clear analytically why, I had a niggle in my mind that I was a little bit uncertain about whether to accept. Thinking about it, I felt I needed to take counsel. Fortunately a close friend, knowledgable in the field, whose judgment I respect, was willing to spend an hour or so going over the matter with me. At the end of the conversation, and more on a subjective basis than as a result of analysis, he said to me: "Harry, they are just not your kind of people". His hunch agreed with my own, and I stood aside.

There is an argument that suggests that a person of integrity may make a contribution in a situation where attributes are mixed good and not so good. My own counsel would be to stand clear. By one's presence one should in effect be saying to stakeholders 'things are OK here'. If there are areas of the business about which one cannot be quite clear, one should not be conveying that implicit message.

The second approach to the confronting of the fiduciary responsibilities of the part-time director to that wide range of stakeholders, is one which takes place outside formal meetings and calls for a fair bit of energy and effort to achieve it. It is informally meeting, talking to, and listening to, the people who have the sensitive full-time roles in the enterprise. One carries responsibility for it, and so one needs to be clear that one exercises that responsibility fully. As those folk respond in that kind of informal conversation, it becomes possible to make assessments of their integrity and their acumen. Either the alarm bells ring, or you say 'This company is well held'.

In my experience, all those people welcome the chance to convey to an interested outside director their assessment of how effective are the financial controls of the company. Assessments acquired in those ways can be a re-assurance when at that meeting one has to consider the reliability of the financial data that flowed through that area. It cannot be done at the annual meeting where you vote on the accounts. It has to be done throughout the year, with diligence and a certain amount of initiative, to see those people and to talk steadfastly and informally with them. It is particularly useful to have such informal talks with internal and external auditors at times throughout the year.

In my experience, they are inclined to welcome the chance to convey to an interested outside director their assessment of how effective are the financial controls of the company. Listen to them. Assessments acquired in such ways can be a guide - and hopefully a reassurance.

It is time to turn from the private sector to the question of audit control in the government sector. In particular it is interesting, as Mr Tink did earlier, to try to identify who it is that carries the responsibility, comparable with that of a company director, to see that all is well financially in the branch concerned.

In government, the function of assuring oneself that all is well ranges over a wide conglomeration of different structures, and I feel for the Auditor-General as he has to look over that field and assure himself in all those areas that things are as they should be. If it is a government-operated business it may well have a board that carries a responsibility analogous to that of a company board. Some such enterprises may be massive — for example, the State Bank; and, until recently, GIO. In a university, the onus is probably on members of Council. Mr Tink was telling us that he feels that weight falling on him. Other responsible individuals may be a section head in a department; a department head; a Minister. In many government agencies there is a very useful process running, of devolution of budgeting down the organisation, and in such a case the responsibility might be felt by the officer in charge of quite a small unit. Some entities will be expense centres, with virtually no revenue activities. They present one question of control. Others will be businesses that operate in a commercial way. Some entities will be receivers of substantial revenues, whether from taxation, or from fees for services.

These situations, diverse as they are, all have similar sets of relationships. Responsibility for financial control and integrity rests with one person who is accountable for its adequacy, but who does not themself do the financial work of the entity. The operations are subject to the surveillance of the Auditor-General; and in all the instances I can think of in New South Wales government, and it is interesting to hear why that is so, there is an internal audit function that answers to top management, and that interacts and is coordinated with the Auditor-General's work.

Whether the scope of the enterprise be small or large, the question remains: How deep should directors delve?

As with the corporate sector, there are quite complex compliance requirements. Systems are in many cases prescribed centrally, and must be used. As an example, in many areas the procurement of goods and services must be in accordance with strict guidelines. The responsible person, the "director", may not necessarily be detail-perfect in all these requirements for compliance; he will nevertheless carry the responsibility to assure himself that the people who carry out the work are technically, and in terms of competence, adequate to their work. The "director" may to a considerable extent be in their hands. He had better be sure that they are competent hands.

Given that my government service has been primarily in banking, and in particular in central banking, I do not feel any strong urge — particularly in the presence of the New South Wales Auditor-General — to share with you my lack of detailed knowledge of government auditing in this State. We shall hear about that later, from someone who does know.

Perhaps I might nevertheless be allowed to mention again the way in which a non-expert company director can work at assuring himself that the financial affairs of his company are being satisfactorily looked after. The approach, you will remember, was to seek out, to talk with, and most important to listen to, the people who have the expertise, and who do the work; and to do that not only in formal briefings and in meetings, but in informal conversation. People love to talk about their pitch, and you can find out and assess by doing that.

That is the heart of what I want to say. It works for the non-executive director. He has to do it if he is going to confront his responsibilities, and a government manager "director" can use that technique to good effect, as well as the controls and systems and meetings and briefings and presentations. Vital as they are, if they are not supplemented by vital, personal contact, listening to people as they talk about their patch, the manager is missing out on a vital part of what can give him assurance that all is well.

An analogous approach can, I am sure, be used to effect by the responsible person in the government sector in familiarising himself with the broad picture of the compliance requirements of his area; in becoming aware of the problems that may be emerging; in making sure that his technical people, including his internal auditors, are talking from time to time throughout the year with the Auditor-General's people — which is a very great help in the whistle-blowing area — and in satisfying himself of the competence, integrity and diligence of those who actually do the financial work of his area. That is, I assume, no real news to the government managers here today; it is plain good management technique. But we tend to let it slip, and we have to keep working at it.

In conclusion, I would say again that high quality financial work is a first-class vocation. For reasons stated at the outset of our time together, I believe it makes a very valuable contribution to the wellbeing of all Australians. I wish you all well in it.

DISCUSSION

Mr TINK: Thank you very much, Sir Harold. Are there any questions?

Mr Jim Kropp

Sir Harold, could you give us an indication of the extent to which you would think, as chairman of a large organisation, you would meet with the internal auditor, say three times a year?

Sir Harold Knight: I could talk about it from the point of view of a couple of experiences. One was as audit chairman for a very large company with establishments all over Australia. The head office where I attended was in Melbourne, and the internal auditor was in Adelaide and the external auditor was in Melbourne. I would talk either face to face or by telephone with the internal auditor something like three or four times a year, not only before the annual meetings. I would encourage him to yarn about what was his work programme, what was his staff, how long had they been with him, what were their professional qualifications, how he got through, what he found, when he got to an operation when he did the asset register, how he assured himself that the expenditure records were okay, and in general I would draw him out in that way.

The external auditor I would talk to perhaps two or three times a year, and certainly as we were into the run-in to that annual meeting where we considered the annual accounts. I was aware that if I turned up at that meeting without having some knowledge as to what was coming down the track I would be in trouble.

Management deals with the external auditor in preparation of those accounts, and there is an inherent tension between the two. Management wants to present the company well. They want to see to it that the valuation of assets is kept reasonably high so that you do not get write-offs. They want to see to it that expenditure is capitalised so that you can write it off over a few years and you do not have a big charge against this year's profits. You bring revenue to account quickly. In general, they have a look around the accounts to see just which windows they can dress a bit to make this year look good. Sometimes they forget there is a following year.

The external auditor, on the other hand, is very concerned with conservatism. As far as he is concerned, he does not want those assets valued above what is a very conservative level. You bring revenue into account when it is earned and you do not try to reach out to the future and put it into this year's accounts. As far as he is concerned, what you capitalise and what you do not capitalise is a very interesting question, and if management gets too frisky on it he would like to set them back a peg or two.

If you come to that meeting of the audit committee or the meeting of directors without knowing what are the issues that are under discussion between the auditor and the management, you are walking into a minefield. So particularly before the annual meeting, when these matters are alive and being discussed, you need to reach out to your external auditor and have a yarn with him or perhaps have lunch with him, and you need to reach for your finance director and find out what his perfectly reasonable side of the story is, and you have to make up your mind as the external director what you can wear and what you cannot wear. If it is all right, well and good. If you need to have something changed, it is very useful if you can get it changed a couple of weeks before the meeting, because if you try to raise it at the meeting and change it you have real problems on your hands. I do not know if that helps you.

My second example was a large Japanese bank which had visitations from Tokyo of its internal auditors from there, and it had an internal audit function which was pretty lively, with which I was in touch. It had good external auditors who had been with the bank from the outset. Frankly, the directors felt they could rest pretty happily in that situation. They did not feel quite the pressure that I have described in the case of the private company in Australia to reach out throughout the year and keep the internal auditor awake, and to reach out through the year and stir up the external auditor.

The preparation for the annual accounts cycle was in that case also a pretty important matter: you needed to be sure that you knew what was going on between the management and the auditors in preparation for the annual cycle. One felt that if anything the audit business was being overdone, and as long as you were in touch with the department heads and you knew that it was being well managed, you took pretty well for granted that the systems were working fine. Maybe that was a false confidence; the directors of that company were pretty happy with what was going on, and did not disturb themselves unduly.

We did not even have the external auditor to the annual meeting where the directors looked at the accounts. We had an arrangement by which he came and saw the chairman and talked to the chairman and shared with the chairman any concerns he had, and that was reported by the chairman to the directors. That was an extreme case in the other direction, and I am quite confident that that was working quite soundly.

Jeff Bergman, Bergman Voysey Associates

My question is, how do you in your role of chairman in a major organisation perceive risk, particularly in your role as chairman or an independent director? You have indicated that you would interview members of the organisation and get a feel as to their integrity and so on. What do you look for and what do you perceive as perhaps the risk to the chairman, to the board, to the independent directors, and more important to the organisation itself?

Sir Harold Knight:

I have spoken only of matters that come within the general periphery of audit and financial integrity, but widening that out the function of the non-executive director is much wider than that. He has to think about whether the company is in the right businesses. He has to think about whether the assets which are being acquired, which are reported to the meeting period by period, are sensible assets to acquire, and if he feels the company is dealing with people who are a bit doubtful he has to say so. This was a particular problem for me, because in the Reserve Bank we had pretty stringent standards of integrity. We were not dealing with anybody who was a shonk. In private business you cannot afford that luxury: you have to deal with some people who you think are a bit shonky. The question of how you handle them, and how a reserve banker who is appointed to a commercial board handles that conflict, is a very difficult one.

I recall that in one company I was with we made loans to a company about the integrity of which I had some doubt. I went down to the company's offices and I went through those loan documents and I found holes in those loan documents. If they had been bank loan documents I would have had them re-written. I raised those questions in writing with the management of the company. I was not at that time the chairman. I said that if this was the Reserve Bank and we had these defects in the arrangements between us and this person, I would close out the dealing and have nothing more to do with him. They are still looking for some of the money they placed with that person, but I think I should have been a bit stronger.

There is a question of how far one goes in a balance between what you might call business astuteness and personal conservatism and integrity. I do say to you that that balance is different in the Reserve Bank from what it is in the private sector. I hope that helps.

Mr TINK: I thank Sir Harold Knight.

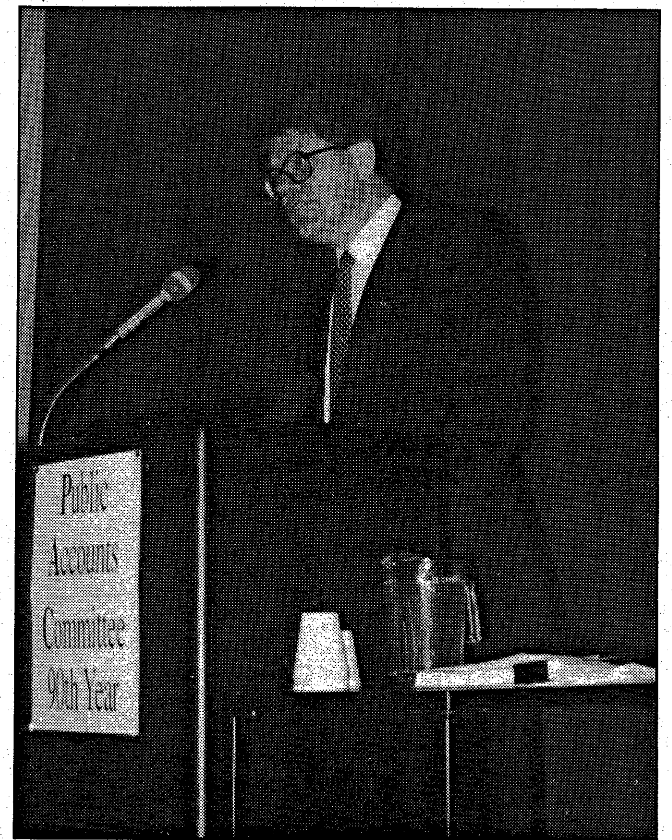
SEMINAR ON INTERNAL CONTROL AND AUDIT

19 NOVEMBER 1992

PARLIAMENT HOUSE SYDNEY

AWA AND OTHER RECENT CASES
WHAT ARE THE LESSONS FOR INTERNAL AUDIT?

MR J KROPP
SENIOR PARTNER, PRICE WATERHOUSE



Mr Jim Kropp, Senior Partner, Price Waterhouse

AWA AND OTHER RECENT CASES: WHAT ARE THE LESSONS FOR INTERNAL AUDIT?

Mr TINK: Ladies and gentlemen, it is now my great pleasure to ask Mr Jim Kropp to address you. By way of introduction, Jim is a senior audit and investigation partner in the Sydney office of Price Waterhouse. He is a member of the New South Wales Treasury Advisory Panel, and member of the Public Sector Accounting Standards Board. He is also National Vice-President of the Australian Society of CPAs. Perhaps relevantly to today, his internal audit assignments include the State Authority Superannuation Board, the Australian Meat and Livestock Corporation, the Environmental Protection Authority, and the Australian Nuclear Science and Technology Organisation.

Mr Jim Kropp, Senior Partner, Price Waterhouse:

Might I congratulate you, Mr Chairman, on the timing of your selection of the topic for me to speak about today. For those of you who have not caught up with it, Andrew Rogers delivered his judgment yesterday afternoon, apportioning damages between the various participants in the AWA affair. He has allocated 72 per cent of the damages against Deloittes, and the papers this morning have an extensive coverage of the problems this will create for external auditors, and they go on at quite some length on that subject of the 72 per cent being awarded against Deloittes.

I want to focus today in my presentation to you on why Justice Rogers apportioned 20 per cent against the company, and as we go through this morning you will begin to see why he has done that.

Mr Kropp then read out his prepared paper, which follows on pages 44 - 59 inclusive.

201 Kent Street. Sydney 2000
Box 4177 GPO Sydney 2001

Telephone (02) 256 7000
Fax (02) 256 7777
Telex 21798
DX 990 Sydney

Price Waterhouse

PUBLIC ACCOUNTS COMMITTEE

SEMINAR ON INTERNAL AUDIT

THURSDAY 19 NOVEMBER 1992

AWA AND RECENT CASES - WHAT ARE THE LESSONS FOR INTERNAL AUDIT?

JIM KROPP, PARTNER, PRICE WATERHOUSE

The USA experience

A couple of years ago one of my American colleagues, Dennis R Schueler of our Chicago office, published his findings, of his research into the effectiveness of internal audit departments. He had conducted interviews of the top management of some of America's largest corporations and had sought their views about the role and benefits of internal audit. Overall, internal control was mentioned most frequently. This role drew such comments as:

- "to review controls for adequacy
- to assist in the design of controls
- to safeguard assets and records
- to ensure compliance with company policy."

The role that ranked second overall was "efficient operations and operational effectiveness".

I will turn to AWA

AWA

I don't intend to quote large slabs of Justice Rogers' decision in the AWA case to you. I have, however, included as an Appendix key references to internal audit in Justice Rogers' judgement. It is a useful compendium and I have not seen it done anywhere else.

Page 2

Of vital concern to management and internal auditors are Justice Rogers' findings that:

> "Management was negligent:
>
> - in the failure to establish a proper structure of internal controls; and
> - 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".

Justice Rogers found negligence in connection with the internal audit at AWA.

Internal Control Weaknesses

As best as I can determine in the AWA case, there were many weaknesses in internal control. These include the following:

1. mail concerning foreign exchange transactions was not reviewed by anyone superior to Koval;
2. there was no system of recording every foreign exchange transaction on an individual dealing slip;
3. no complete contracts register was kept;
4. no complete daily summaries of transactions were kept;
5. no ledger of foreign exchange transactions was kept;
6. exposure reports concerning open positions were incomplete;
7. there was no written prescription of segregation of duties or responsibilities of staff;
8. Koval was solely responsible for foreign exchange dealing and also had responsibility for settlement and accounting functions. One bank (Barclays Australia) was informed in writing by AWA that Koval was authorised to confirm as well as enter into foreign exchange transactions;
9. there were no written dealing guidelines that imposed limits on Koval;
10. there was no revaluation of outstanding contracts on a periodic basis and posting to general ledger.

Page 3

Internal Audit and FX

I understand that the AWA internal audit team did not conduct any specific audit program for the FX operations. However, in early 1987, to quote Justice Rogers, "A loan of US$822,858 from Macquarie Bank to AWA was discovered" and "... [internal audit] also became aware of a cheque requisition for a repayment of a loan to Macquarie Bank".

"[Internal audit] sent a memorandum to [management and the external auditors]".

All of this indicates that internal audit were aware of significant deficiencies in internal control and record keeping procedures, as follows:

1. Foreign exchange register was not being properly kept.

2. Substantiating documentation was not being regularly maintained nor files.

3. Foreign exchange was a large part of AWA's activity and yet "It is also obvious that the accounting is done on an 'ad hoc' basis ...."

4. Items in dispute with a bank had not been followed up on a timely basis.

5. It was "imperative" that the foreign exchange systems and record keeping area had to be updated and strengthened.

Duties of Internal Auditors

So I can not see any action being taken by internal audit to follow up on a timely basis these significant breakdowns in internal control. In my opinion, internal auditors have a responsibility to report significant breakdowns in internal controls to senior management. In some organisations internal auditors also had a responsibility to report directly to the Audit Committee as a procedure in the ordinary course of events. In my view, all internal auditors have a responsibility to report directly to the Directors a significant breakdown in controls where senior management had failed to act.

There was no Audit Committee at AWA and one can only speculate that such a committee may have had a material impact.

Let me state now the core lesson for internal auditors from the AWA case; it is the reason why Justice Rogers, as I said earlier, described management as being negligent through 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.

Here is the lesson. The matters discovered by internal audit represented significant weaknesses in the controls and authorisation procedures which meant that the company was subject to significant exposure. These matters should have been but were not reported to the senior management of AWA or the Board of Directors of AWA as a matter of urgency. If they had been reported to senior management and senior management had failed to act, they should have been reported to the Board of Directors.

Justice Rogers has not set a new standard for internal auditors. Frankly, in my view he has not even set a new standard for external auditors. He has clarified their responsibilities. I must observe, he has also clarified the responsibilities of management and directors.

Some of you may be disagreeing with me on this point. Has Rogers imposed a higher order of responsibility upon Internal Auditors? Do they now have a new "whistle blower" type of responsibility to the Board?

The Institute of Internal Auditors

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

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

As I mentioned in my opening remarks, my colleague, Dennis Schueler, in his research on the expectations of internal audit identified that the internal control role was mentioned most frequently as being the prime function of internal auditors. Justice Rogers has amply confirmed those findings.

Action now

What action is now required? There are two broad subjects flowing out of Justice Rogers' findings which require the attention of management and internal auditors. These are the structural effectiveness of an internal audit department and risk based audit methodologies.

Structure

To assess whether or not "an internal audit department measures up" and Justice Rogers in AWA in their situation had his doubts there is a substantial series of questions. My firm, for example, has a whole questionnaire on that particular subject. However, the answers to the following handful of questions will either provide assurance or, alternatively, discomfort to an evaluator of an internal audit department.

Role and scope of activities

Page 5

- Is there a policy statement defining the department's purpose, responsibilities and authority?

The effect of organisational status on independence

- Is the department's organisational status consistent with the importance of its assigned responsibilities?

Personnel - a critical factor

- Is the audit director a capable, articulate executive with a strong technical background?

Internal audit department management

- Is there a comprehensive audit plan which provides for coverage within a reasonable time frame of all audit areas for which the department is responsible?

Demonstrated performance

- Do audit recommendations receive prompt consideration and result in prompt remedial action or sound reasons for rejection?

External quality assurance reviews

- Should an external assurance review of the internal audit department be considered at this time?

You may wish to answer these questions yourself. Does the internal audit department measure up? Is it structurally effective?

Performance

This line of thought will quickly lead to the measurement issue. What are the appropriate Performance Indicators?

Input measures

(a) cost of audit staff and resources used

(b) proportion of staff time spent on planned audit tasks

Output measures

(a) progress against planned work

(b) number of audit reports

(c) level of audit recommendations implemented

(d) level of savings/recoveries identified

(e) number or value of frauds detected.

Risk methodology

I now turn to the subject of the risk based Internal Audit methodology.

A couple of words keep leaping out from Justice Rogers' judgement in the AWA case. These words are "exposure" and "risk". Auditors, both internal and external, today must employ the latest risk based audit methodologies in order to focus their attention on those auditable areas which are of greatest concern and in order to keep abreast of changing developments within any organisation.

I will use my own firm's methodology as an example of international best practice.

Internal audit should be specifically designed and tailored to help the organisation achieve its objectives and goals. This is "top down" not "bottom up". Internal Audit achieves this by:

- supporting and enhancing the management process and addressing specific needs;
- auditing the factors critical to achieving objectives and goals successfully;
- reporting independently to the Audit Committee or Board on areas that are not contributing adequately to the achievement of objectives and goals;
- ensuring management, focus on those areas that are most important to the organisation as a whole, where the potential for improvement or risk of failure or loss is greatest.

Internal Audit has enormous scope to focus senior management's attention on issues that are critical to the continuing success of their business. Are Internal Auditors in touch with and contributing to strategy?

The key to a risk based methodology is to focus specifically on the risk profile and critical success factors of an organisation.

Our methodology also involves a continual reassessment of assumptions and critical success factors developed in the top level of strategic planning based on emerging conditions. This takes me back to the AWA case. Rogers draws

Page 7

attention in several places to the new conditions that developed within AWA. This leads me to some thoughts on responding to change.

It may reasonably be assumed that although audit objectives will always be the same, methods of achieving these objectives will not. Business methods will change, new legislation will be introduced, technology will continue to develop and the policy maker's perception and expectations of internal audit will alter. Furthermore, whilst severe economic constraints continue to affect the public sector there will be pressure to reduce audit costs and/or coverage towards the minimum.

Four areas of change are looked at somewhat briefly below. They are:

(a) Recognition of the political environment

(b) The need for audit to demonstrate cost effectiveness

(c) The impact of new technology

(d) Contracting out the internal audit function.

Recognition of the political environment

The excesses of the 1980s in both the Public and Private Sectors are bringing forth appropriate responses. That this seminar is being held is evidence itself of the great importance being restored to Internal Audit. Internal Auditors have always been professional; they are now going to be measured against the benchmarks of best practice.

The need for audit to demonstrate cost effectiveness

In the current climate of financial restraint, there is a much greater awareness of the impact of central management and administration costs, particularly in Government Business Enterprises.

In the circumstances, there is a pressing need for the central departments, including the internal audit section, to justify their costs by demonstrating their worth and effectiveness. The response to this challenge may take the form of:

(a) the demonstration of the effective use of resources as evidenced by adequate planning and control systems, and also the development of performance measures.

(b) the production of useful reports for management which are regarded by the recipient as helpful, rather than as negative statements of petty shortcomings.

It may be of benefit to discuss the agreed areas of planned activity with heads of departments in addition to the Chief Financial Officer. If possible, there should be an emphasis on both operational and systems audits.

The final plan must be approved by the Chief Executive who has ultimate responsibility for Internal Audit, under the Public Finance and Audit Act.

To effect a change of image, the audit section must be properly equipped in terms of manpower and personal skills, including specialists in particular fields. In addition audit must have a high degree of confidence in its own ability to perceive problems and provide practical solutions. Audit must then be able to sell itself as a service with a valuable contribution to make to the overall efficiency of the organisation.

In order to promote the audit image more effectively some organisations have produced a pamphlet outlining the role, objectives and working methods of the Internal Audit Section. This is distributed both to policy makers and managers who may have contact with audit and is a useful device for dispelling illusions and creating a positive attitude to the audit function. Have you done this?

The impact of new technology

Auditors should perhaps give some deep thought to the impact of new technology. There may be fear or resentment insofar as development or innovation may lead to redundancy or altered career paths for some. Whilst it is management's role to deal with the human problems by way of education and training, the auditor should be aware of how people might react in these circumstances and endeavour to ensure safeguards are employed where necessary.

As organisations do become more dependent upon computerised systems, the loss of which could have a major impact on an organisation's ability to fulfil its function, managers and auditors must be aware of the potential risks resulting from total or partial loss of computer support. Auditors should know how and where risks and hazards can occur and endeavour to ensure that some provision exists to ameliorate any loss or malfunction. Normally, there will be a disaster recovery plan and audit should be aware of the proposals contained within it, and of the role which audit may be required to fulfil in any significant emergency.

Contracting out Internal Audit functions

Private Sector accounting firms acting in a consultancy capacity are currently employed on a wide range of duties including Operational Audits, information systems and compliance audit. Some of the smaller authorities are contracting out their internal audit function, where they are disinclined or unable to provide an in-house service. In some cases external sources are employed to provide a complete service, but there are other instances where Private Sector firms actually manage full time, in-house staff. In yet other organisations only specialist skills, such as computer audit, are brought in, the rest of the section being employees of the organisation.

Contracting out normally requires the negotiation of a fee with the consultant, based on an agreed number of days work. This means that consultants work under some pressure. On the other hand it has been the experience of some organisations that tighter target times for the preparation of reports can result in superficial coverage. This must be borne in mind when attempting to keep down costs.

Interestingly AWA has echoes in

ANAO Report 50

The Australian National Audit Office has conducted a further review of Internal Audit in the Commonwealth and released its findings in Audit Report Number 50, in June 1992. The principal recommendations are:

> "**Key Outcomes**
>
> **Findings**
>
> There is increased recognition of the value of internal audit. Managers and Boards want additional assurance on the adequacy of financial and other management controls. Because of its independence, standards and systematic approach internal audit is best placed to provide such assurance.
>
> However, the role of internal audit is unclear. Internal audit is extensively involved in tasks not traditionally part of its role, such as fraud control, program evaluation and management consultancy. Care is needed lest this involvement compromise internal audit's independence or the completion of its primary program.
>
> The scope of internal audit was not always satisfactory. In some organisation reviewed, the mix between compliance, financial or performance auditing reflected an appropriate strategic choice. In others it reflected a poor understanding of internal audit's potential.
>
> Overall, the Australian National Audit Office (ANAO) found that internal audit performance had improved since its earlier survey, especially in audit planning, organisation and staffing, and liaison with line management.
>
> However, in relation to other important requirements - auditor productivity and skills, audit task management and quality assurance - internal audit performance needed to improve further.

The Audit Committee is a key instrument for improving internal audit. The ANAO found that Audit Committees worked best where their members had an independent perspective, expertise and commitment. Departmental Audit Committees can be strengthened by having expert independent outsiders as members.

Recommendations

Further to its recommendations in Report No. 6 (included at Appendix 1 of this Report) the ANAO has recommended that the Department of Finance:

- propose to Government that the new financial administration legislation require all Commonwealth organisations to:
  - develop and maintain appropriate internal audit plans and programs, and
  - establish appropriately constituted audit committees to, among other things, monitor and review internal audit plans or programs,
- issue directions specifying the objectives and standards governing internal audit programs and the operations of Audit Committees, and
- establish and support a consultative group on internal audit in the public sector.

The Department of Finance, though disagreeing on some details, supported the general direction of the ANAO's recommendations. The selected organisations which responded, welcomed the ideas put forward, but cautioned against the legislation being too prescriptive.

Impact

The ANAO believes that its comprehensive review of internal audit will:

- increase internal audit's contribution to improving public sector accountability and administration,
- promote greater understanding by management and Boards of Directors of internal audit as a key management tool, and
- better disseminate best practices throughout the Commonwealth public sector."

Page 11

From all of the foregoing one can see that the AWA case and other recent cases have reconfirmed longstanding principles. In summary, internal auditors must maintain the highest professional standards.

What are those professional standards. In August this year the Australian Accounting Research Foundation issued an auditing statement "Explanatory Framework for Guidance on Audit and Audit Related Services". This is authoritative guidance for both external and internal auditors in both the Private and Public Sectors. In connection with internal auditors, that statement recognises that members involved with the provision of audit and audit related services as internal auditors have a professional obligation to adhere to professional statements on audit and audit related services.

At a recent meeting of the Public Sector Accounting Standards Board I made enquiries about the probable course of action that would be pursued in connection with Exposure Draft 29 dealing with the Statement of Applicability of Statement of Auditing Standards and Statements of Auditing Practice to Internal Auditing. Now that the explanatory framework has been issued in August 1992, the Auditing Standards Board will probably return to some of these earlier Exposure Drafts and, I believe, they will be strengthened.

ED 29 has a final word on Internal Auditors duties:

> "An important role exercised by an internal auditor is to report appropriately to the Board of Directors or other governing body any matters that in the opinion of the internal auditor should be reported. Examples of such matters would be cases of waste, mismanagement, fraud and material non-compliance with controls.

All of the indicators, recent cases, overseas developments and Australian auditing standards point to an increase in the professional requirements for internal auditors.

One of my other roles is National Vice President, of the ASPCA with responsibility for Centres of Excellence including the PSACOE in Canberra. I believe that we now have the opportunity to make our profession of internal audit in the public sector, itself a "centre of excellence".

JF Kropp
Price Waterhouse
Sydney

19 November 1992

APPENDIX

THE AWA CASE AND INTERNAL AUDIT
EXTRACTS FROM JUSTICE ROGERS' JUDGEMENT

DRAMATIS PERSONAE:

KOVAL	=	FX DEALER
BELFANTI	=	INTERNAL AUDITOR
DANIELS	=	EXTERNAL AUDITOR
GIBSON		)
MILEHAM)		
WICKHAM)	=	MANAGEMENT
ALAENA		)
CRANE		)
HOOKS		)
RESPINGER		CONSULTANT

Page 5

It is also appropriate to highlight at once the fact that the obligation to limit and control Koval lay on the management. Management failed in this task. The next layer of responsibility rested on the internal auditor of the plaintiff. He also failed. The loss occasioned by the failure of management to do its job properly and the failure of the internal auditor to detect that, is now sought to be sheeted home, in its entirety, to the auditors on the basis that their failures were a cause of the loss.

Page 6

It is appropriate to mention another matter that may well have contributed to the difficulties in the timely detection and termination of Koval's activities. Daniels, the General Manager Gibson, and the Internal Auditor Belfanti, were friends of long standing.

Page 55

According to Daniel's statement, in accordance with his practice of raising matters with Gibson and Belfanti, Daniels would have discussed with them what Koval had told him.

Page 63

That is the failure of the auditors to draw attention to absence of or gross deficiency in internal controls and in the systems of records and accounts.

Page 65

i. Inadequate Records Maintained and Retained

Page 2

Page 70

ii. Inadequate Systems of Internal Controls

Page 71

iii. Inadequate Management Overview and Monitoring of the Foreign Exchange Activities

Page 79

INTERNAL CONTROLS

Belfanti accepted (Tp 804) that the function of the internal auditor was to draw the attention of management to deficiencies in internal control and it was for management then to ensure that the necessary steps were taken. That did not happen in the case of AWA. If indeed Belfanti did his job, Gibson and Mileham failed in theirs. There is no evidence whether Belfanti in fact did anything to draw the attention of Gibson and Mileham to the deficiencies. In a sense it does not matter because Daniels did so. Nothing happened.

Page 93

Daniels was encouraged in the approach he was taking to the absence of internal controls by his belief that if he drew the attention of Gibson and Belfanti to any problems they would be promptly attended to. He met with them at least two or three times each week during the carrying out of an audit. He would then discuss any specific issues and in the past, problems had been addressed by them promptly and satisfactorily (Daniels Ex D21 par 13). He drew their attention to the problem of absence of internal controls in June. He was aware that they did nothing.

Page 95

Daniels himself recognised the need for change by the suggestions that he made to Gibson and Belfanti in June.

Page 112

Belfanti knew of at least two FX loans obtained by Koval. A loan of US$822,858 from Macquarie Bank to AWA was discovered during the February 1987 internal audit review. Belfanti asked Koval what the loan was about and Koval said "It was a Deutschmark FX contract profit offset. I'll look into it and come back to you." He did not do so. Belfanti sent a memorandum to Wickham, Gibson, Mileham, Koval and the auditors.

Page 3

On 23 June 1987 Belfanti also became aware of a cheque requisition for repayment of a loan to Macquarie Bank.

Page 113

Wickham also received a copy of Belfanti's memorandum of 30 April 1987 referring to the loan from Macquarie Bank of $822,858. He admitted (Tp 865) that he took no action about the loan other than to seek advice from Mileham and Koval.

In the result, from 30 April 1987, when he received the Belfanti memorandum Wickham was aware that Koval had borrowed foreign currency. He appears not to have been concerned at the fact and took no steps to either bring to an end Koval's borrowing activities or notify any banks that Koval was not an authorised borrower.

Mileham was also the recipient of Belfanti's memorandum of 30 April.

Page 114

Gibson was another recipient of the Belfanti memorandum of 30 April and apparently did nothing.

Page 125

The meeting was held on 28 October 1986. There were no directors present. Daniels and Laidlaw attended from the auditors and Mileham, Alagna and Belfanti from AWA.

Page 127

The defendants elicited from both Belfanti and Respinger that the nature of the Lotus system in the first instance and the Macquarie system later would impact on the types of internal controls to be put in place. Thus, Belfanti said (Tp 901) that 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.

Page 128

In the result, so far as the evidence reveals, no manual was ever prepared and certainly the deficiency in internal controls continued.

Page 4

Page 158

The submission by the defendants that Wickham, Belfanti, Alagna, and Crane were all aware of loans made at the instance of Koval by late April and early May, yet they did not react in any way to that information, except to proceed to settlement of the loans is fully justified.

Page 176

Daniels had told Gibson and perhaps Belfanti in June or July of the inadequacy of segregation of duties and responsibilities and other defects in records and internal controls. However for two and a half months thereafter senior management had done nothing.

Page 188

It is true as urged by the defendants that the Board as a whole was not infused with a sense of urgency when the letter dated 4 December 1986, recommending improvements to the existing AWA internal audit was placed before it. The Board deferred dealing with the question at its December meeting and stood it over to the February meeting. Hooks explained (Tp 290) that he regarded the letter merely as suggestions for a more economic discharge of the internal audit function. The other directors asserted that they also did not read the letter as suggesting any deficiency in internal control.

Page 219

Management was negligent in:

(iii) the failure to establish a proper structure of internal controls

Page 220

(iv) 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

(ix) Gibsons's and Belfanti's failure, from June 1986 to act on Daniels' warning that it was essential that accounting procedures in relation to FX be improved forthwith

Page 221

A minimum requirement to be satisfied on the part of management included:

1. establishing a proper system of internal controls at the outset when the operation was centralised at corporate headquarters. This was not done. Then when Daniel's drew attention of Gibson and Belfanti to this failure

Page 5

nothing was done. When reference was made to it at the audit exit meeting in October nothing was done.

Page 237

As well, senior management must have known of the existence of the FX loans, because, repeatedly, payments were authorised, both of principal and interest, relating to loans taken out by Koval. Again, by a memorandum of 30 April 1987, Belfanti informed Wickham of a loan of US$822,858 from Macquarie Bank. Copies went to Gibson, Mileham and the auditors. Wickham simply asked Mileham and Koval to respond to Belfanti. Other loans were referred to Wickham by Crane. Nothing, or nothing effective, was done to investigate these loans.

DISCUSSION

Peter Forster

I am an internal auditor and consultant. I retired some years back from the University of New South Wales. I think it appropriate to make some comment, if I may, rather than a direct question, although if there is a question implied Mr Kropp will no doubt answer it. May I briefly quote from what I wrote some time back on the AWA case, and let us be quite clear that this was a private sector company. I said:

> *Internal audit is confined to its brief from management and is then further constrained by policy directives and by the limitations imposed by the resources made available to the audit group for that task. Internal audit cannot be fully effective, autonomous and independent unless there is a clear charter in writing which includes the right of direct access to the board of directors, preferably as a member of an audit committee.*

On the evidence, AWA did not empower its internal auditors in that way. It did not provide for direct access to the board, did not have an audit committee, and appeared virtually to have made a no-go area of the foreign exchange trading function.

I might add that I spent some two or three weeks researching the facts and talking to the parties most directly concerned. I would then like to make three points. I think it is a serious mistake to read the judgment of Mr Justice Rogers too literally. He himself deplored the lack of adequate evidence on internal audit and also deplored the failure to call key people as witnesses. That reminds me of a comment, a sort of judgment, made by one of our most senior jurists, who said 'You know, Peter, our adversary system is really a conspiracy to keep the truth from the court'. That is to say, it reflects the tactics of the advocates on each side.

I think with respect that Mr Kropp overstates the significance of the judgment in relation to internal audit, for the reasons I have mentioned. However, I do not defend the external auditor's default in failing to tell the full board.

Let me then state this. As far as I have been able to ascertain, the external auditor and senior management in this case were engaged in a damage containment exercise in an effort to protect the company from a hostile take-over bid, in this case from Universal Telecasters. That the external auditor, rather than the profession, made a serious error of professional judgment, I think goes without saying.

As far as the internal auditors are concerned, as I have said, their brief was limited, their staff was limited, and the foreign exchange area was virtually a no-go area, and we had the totally unsatisfactory situation where the chairman of the board was also the chief executive of the company, and in effect blocked information that was obviously going to him.

There is clear evidence of human weakness there under pressures from management, and serious errors of judgment by that one external auditor; but I think it is a gross injustice to the internal auditor who was concerned and the internal auditing profession as a whole to attempt to read from Mr Justice Rogers's judgment any kind of clear opinion as to the internal audit function which I think he confesses not clearly to understand.

Mr KROPP:

Looking at what Rogers said about management, one would certainly have to be very concerned about a suggestion that internal audit in fact was constrained from looking at FX operations. I understand that the AWA internal auditing team did not conduct any specific programme for the FX operations. However, early in 1987, to quote Rogers, a loan of $800,000 from Macquarie Bank to AWA was discovered, and internal audit also became aware of a cheque requisition for the payment of the loan from Macquarie Bank. Internal audit sent a memorandum to management and the external auditors about this matter. So I do not agree with the speaker, though perhaps I should not argue from the lectern. The internal auditors did become aware of some troublesome matters, and Rogers says that they failed, and this is under the heading of the negligence part of his judgment, to follow up such defects and queries as it did raise.

Further, which I did not quote to you, 'Gibson's and Belfanti's (that is audit's) failure from June 1986 to act on the external auditor's warning that it was essential that accounting procedures in relation to FX be improved forthwith'.

He goes on at some considerable length about the inactivity of both management and internal audit in this area, they having become professionally aware of these matters.

I understand fully the point that an internal audit department may be constrained by resources, but when you kick your toe on something you are then on notice, whether you are an internal or an external professional auditor, to do something about it. We have had discussion here this morning about whistle-blowing, and I referred to the various professional statements by the Institute of Internal Auditors and the Auditing Standards Board exposure draft, which I think will be strengthened, not diluted.

I think that as a professional auditor, and I practise both internally and externally, I have never doubted my professional obligation when I see something that concerns me, to take action. As a junior audit staff member when I first joined my firm, and I know this applies in professional internal audit departments as well, not following up or recording things in the working papers. I can remember quality assurance reviews in my earliest days of somebody looking at a thing and you found a weakness and you did nothing about it. As a junior auditor if you did not report it to the senior auditor it was a cardinal sin.

I am very concerned about any suggestion that any professional auditor, chartered accountant or CPA, NIA or any professional auditor who comes across a matter of concern, must see that appropriate follow-up action is taken. Otherwise he runs the risk of appearing in a court judgment and at worst, when I was chairman of the disciplinary committee of the Australian Society of CPAs he might even have had to run through the investigation process. It is a very serious thing.

Mr Jeff Bergman, Bergman Voysey and Associates

I just wanted to ask your view of AUP27 which I believe gives good guidance to auditors in terms of Materiality and Audit risk. You did state that you saw a progression in internal audit with the emphasis changing from compliance audits to operational audits.

Could you give us your views on the percentage of time that should be spent on Audit Planning and Risk Assessment?

Also, what are your views on time required for special investigations and project evaluations by internal audit?

Mr J. Kropp:

Typically I am seeing progression in internal audit. There seems to be almost a natural progression that as internal audit turns to a comprehensive risk-based methodology, probably in the first year there will be one hundred per cent of the effort devoted to compliance and systemic auditing. That is the traditional role of the internal auditor and I have tried to address that.

Then as time goes by and internal auditors become more and more focussed on areas of exposure and the critical success factors — and that is a very interesting subject for internal auditors, to be talking to their chief executives about what are the things that have to be done well. Does the chief executive know what they are? Is he evaluating the performance of his senior staff? Is it in their contract? These are key things that have to be done well, so what are the critical success factors and what are the things that are very important to be done in the organisation?

Some of those things may not have a reference to internal accounting control at all. Then he will start to move away as he becomes more and more skilful and has access to the right resources. He will move away from the traditional role of systems and compliance audits and the risks of non-compliance with internal accounting control, into more operational audit areas. I said 50-50. I think when one got to 50 per cent compliance audit one would probably be spending then 40 per cent on operational audit and 10 per cent on what I would call diagnostic reviews, using your good common sense and getting around sniffing out where there were trouble spots, doing some kind of status report analysis, and asking the obvious questions about where things might be going wrong. As you reduce the amount of compliance work you do, that in itself means you are not going to get around the whole organisation in the same sort of detail. You have to have something that gets you over to sniff out the trouble spots. That is where you need skilled people. It would probably be 50-40-10. It would be the best one would aim for. If you were doing only 20 per cent of compliance work, then those directors who ask 'Is the organisation exposed?' might be receiving a false sense of security about the coverage by internal audit. That is where I get my broad figures.

S Ciemiega, Department of Water Resources

In your engagements as an internal auditor did you ever find that there was nothing wrong with an organisation or with an area you have audited <u>the</u> area that you have audited, that everything in the garden was lovely and rosy. Is it a danger then for you or your staff to find some imaginary faults in order to justify your existence, to justify your engagement and your fee? The management of the organisation might then ask why they had to spend thousands of dollars on your engagement, or question your competence?

Mr KROPP:

I have not reached that stage of Nirvana yet where there are no weaknesses, but let me assure you that the most professional audit committee that I report to does not want to hear about the detail of our audit findings. They want to see me and they want a report from me that sets out my findings in some kind of priority, A, B, C, and D, and the reports I have issued are a very simple statement and how many category A things there were, and B, C and D, and they might talk to me about those category A findings, but they do not want to hear about the details. They are all busy professional directors and they do not want a lot of detail. They want the assurance from me that there has been adequate coverage. They want to know about the nature of the findings and the implementation by management, and really it is all exception type reporting. If they are getting comfort from me and all of my material recommendations have received attention from management, then that particular audit committee, a very fine group of professional directors, are satisfied.

I do not think there is any need to overburden the justification for one's existence. The quality of the relationship with the Audit Committee, and the comfort I give them professionally should be sufficient to justify one's existence without a make-work exercise.

Stephan Prescalo: I am internal auditor for OPSM Protector Limited. To what extent should the external auditor become involved in setting the annual internal audit plan?

Mr J. Kropp:

I like this question because I am an external auditor, and when I have my external auditor's hat on, I like to think that the internal auditors are working for me. But when I have an internal audit hat reporting to management, I make it very clear that the role of the internal auditor has very little to do with the external auditor. If by coincidence one's internal audit methodology has sufficient power that it identifies all the major areas of exposure, then hopefully the external auditors will be able to rely upon it. But as an internal auditor you are providing a service to management, and you are providing assurance to the audit committee and to the board that all the major exposures have been identified.

Your methodology will not be cut by the financial statements. It will be looking at the management process and at auditable areas within the business. It might only be a coincidence that it aligns with the needs of the external auditors. Having said that, I think there ought to be and there will be proper co-operation and liaison between the internal auditors and the management of the Auditor-General's office, so that everything else being equal there can be proper reliance upon and use made of the internal auditor's work by the external auditor.

But you are not working for the external auditor. That is where I come from. If it is all put together properly, then your work should be developed and structured in a way that can be relied upon significantly by the external auditor. Some of the problem may be with the external auditor's methodology. He may still be systemic, bottom up, and you are trying to come at it risk-based, top down. The problem may be his, not yours.