

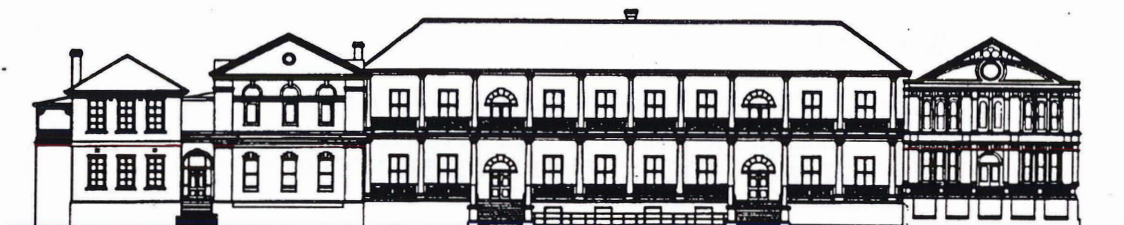


# **PUBLIC ACCOUNTS COMMITTEE**

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## **Proceedings of the Seminar on Internal Audit — Implementation of Change**

**12 November 1993**



Report No. 78

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# MEMBERS OF THE PUBLIC ACCOUNTS COMMITTEE

## **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, its representative on the Macquarie University Council, and a member of the Committee on the Independent Commission Against Corruption.

## **Mr Peter Cochran, MP, Vice-Chairman**

Following a background in farming, the Army, the Commonwealth Police, ASIO, and the Cooma-Monaro Shire Council, Peter Cochran won the seat of Monaro for the National Party in 1988. His other parliamentary responsibilities include the chairmanship of the Minister's Advisory Committee on Land and Water Conservation, deputy chairmanship of the Committee for Police and Emergency Services, and membership of the Committee for the Environment and the Select Committee on Public Sector Superannuation. He is also the Premier's representative on the Anzac House Trust and the Anzac Memorial Trust.

## **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, FCPA, 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 Leader 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 and a Paul Harris Fellow, an active member of the Anglican Church, and the Legislative Assembly member on the Board of Governors of Charles Sturt University. Other parliamentary responsibilities include chairmanship of the Minister's Advisory Committee on Health, and vice-chairmanship of the Minister's Advisory Committee on Roads and Transport.





**The Public Accounts Committee**

**From left: Geoff Irwin, Ian Glachan, Andrew Tink (Chairman), Terry Rumble, Peter Cochran (Vice-Chairman)**

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## CHAIRMAN'S FOREWORD

The speedy and comprehensive response by the Treasurer to the Committee's report on *Internal Audit in the New South Wales Public Sector* is proof indeed of the importance of internal audit and of the significance of the Committee's recommendations.

The implementation of the recommendations will go a long way to ensure that the New South Wales public sector maintains its lead in internal control and audit so as to enable top management to control the State's resources for the benefit of all.

The winning of the 2000 Olympics for Sydney has posed major opportunities and challenges for all public sector management. The massive infrastructure projects to be completed in time for the Olympic games will involve the outlay of considerable funds. The implementation of strong systems of internal control including internal audit can be seen as a safeguard for the public interest. The Committee is pleased to note that the Sydney Organising Committee for the Olympic Games, the body established to co-ordinate the State's role in staging the games, is to be a statutory authority under the terms of the *Public Finance and Audit Act 1983* and therefore subject to the internal control and audit provisions of that Act.

This seminar was organised in conjunction with the NSW Treasury, and for this we are grateful. This close co-operation between the Public Accounts Committee as the review agency of the Parliament, and the NSW Treasury as a central agency of government, is again a major step in the implementation and maintenance of strong systems of internal control and audit in the State.

My parliamentary colleague, the Hon. Peter Collins, QC, MP, Treasurer of New South Wales and a former member of the Public Accounts Committee, opened the seminar and stated his support in very definite terms for the concept of internal audit, and indeed his support for *mandatory* and *effective* internal audit. The need for independence from line management functions for the internal auditor was also stressed by the Treasurer.

Bob Scullion, Assistant Secretary of the NSW Treasury and Chairman of the Internal Audit Bureau, gave an informative talk on how the Committee's recommendations are to be implemented. It is indeed pleasing for the NSW Treasury to indicate that some 95% of the Committee's recommendations are fully supported by the NSW Treasury, with the balance supported in general terms but requiring consultation with other agencies before implementation.

The Auditor-General, Tony Harris, indicated in his address the strong support of his Office for internal audit, and in a most practical way indicated that his Office was now making available relevant parts of its training package to internal auditors who had expressed interest in working more closely with their external auditors. This is a major achievement and is fully supported by the Committee.

A last minute addition to the programme was an excellent paper on public sector audit committees prepared and presented by James Guthrie from the School of Accounting of the University of New South Wales. James Guthrie's paper summarised a survey of public sector audit committees aimed at establishing

"best practice" for public sector audit committees.

The Committee fully supports the academic study of internal audit and internal control. Not only does this add to the body of knowledge on the subject, but the active involvement of academics should ensure that their students, as managers of the future, should obtain and develop the skills and competencies needed if the thrust and aims of the report are to be maintained.

To my fellow Public Accounts Committee members I acknowledge their interest, encouragement and support in promoting the Committee's work in a bipartisan manner. This bipartisan support is typical of the way the Committee operates and ensures the continued advancement in public sector financial management which will benefit all the citizens of New South Wales.

This report presents the speeches given at the seminar, as well as papers by the Auditor-General and James Guthrie that were distributed at the seminar. The speeches have been edited to improve readability, but the papers have been reproduced without modification. To facilitate this report standing alone, the terms of reference for the inquiry into internal audit and the recommendations from that inquiry are included as appendices.

The success of the seminar could only have been achieved with the willing and dedicated efforts of the Committee's Secretariat and the NSW Treasury officers who provided organisational and administrative support. Our special thanks are due to Fiona Adamson and Minh Nguyen from the NSW Treasury who provided administrative support and front-of-house services on the day of the seminar. A special acknowledgement is

made to Carole Worland who transcribed the recording of the seminar.

These proceedings were compiled by John Lynas and edited by Ian Clarke, both of whom were principally responsible for the production of the Committee's report on internal audit. Wendy Terlecki set the report out in this very clear presentation.



Andrew Tink, MP  
2 February 1994



**SEMINAR  
PRESENTATIONS**

## OPENING ADDRESS

**The Hon. Peter Collins, QC, MP, Treasurer and Minister for the Arts**

Parliamentary colleagues, ladies and gentlemen. First of all, you will forgive me if I feel there is some note of celebration this morning. Those of you who heard early morning radio interviews today would have heard that we have retained our AAA rating. Standard and Poor's announced last night (about midnight) that we have retained our AAA rating, and they have also reaffirmed the State's A1+ short term rating in their recent review, so that is a ringing endorsement of our economic management in this State and very welcome news. As Treasurer, I must say it gives me a great sense of relief to know that we are not going to be looking for an extra \$30-\$100 million a year in interest payments which would be necessary were we to lose that AAA rating, so we and Queensland are the only States in the Commonwealth to have that AAA rating good news.

Now while internal audit must strive to maintain its independence, it is still part of the organisation. Therefore, internal audit must have and must be seen to have, full support from the chief executive and from other senior executives of the organisation. If one scans the Auditor-General's reports in recent years, it is not uncommon to find comment that particular internal audits have not been effective.

It is good to see so many of you here today. Let me say that I would like to make it clear that in my role as Treasurer I fully support the concept of mandatory and effective internal audit. All of us need to recognise internal audit for what it is—a key management tool. In fact, it's very often the front line

defence for management. Internal audit is defined by the Institute of Internal Auditors as "an independent appraisal within an organisation to examine and evaluate its activities as a service to the organisation". This means the review of all of the organisation's financial and non-financial activities, and so the scope of internal audit is, in theory at least, limited only by management's discretion and the auditor's own skills and resources. The one thing that distinguishes internal audit from other internal review mechanisms is its independence. This special independence requires internal audit to make objective and disinterested appraisals in support of management's pursuit of excellence.

I believe this often has to do with the fact that internal audit is not highly valued within the organisation. Well it is absolutely essential that internal audit provides demonstrated value in its advice. Advice must be relevant, appropriate and must show an understanding of management's perception and concerns about the corporate environment and business risks. It also needs to meet management's expectations of the appropriate scope, nature and level of internal audit activity. So, advice from internal audit needs to be constructive, be clear and concise, identify the issues, be backed up by sound analysis, and it needs to provide practical solutions.

The final point I want to make about internal audit in general, is that people working in this area must be professionals, professionally trained, professionally committed. Well, I want to say, in summary, that the following

are the requirements for an internal audit—independence; it needs to deliver an important management service; it needs to add value; it needs to give constructive advice, not just criticism; and it needs to be professional.

I believe internal audit has done reasonably well in the New South Wales public sector, but of course, there is room for improvement. The Public Accounts Committee, under the Chairmanship of my colleague, Andrew Tink, has produced an excellent report with a series of recommendations which, when implemented, will ensure that internal audit in the New South Wales public sector is modern, relevant and effective. The only word of caution I sound is that successful implementation will largely depend upon you, the management of the line agencies. Treasury will arrange the necessary legislative changes, subject to the consent of the Parliament (which cannot always be assumed), to alter the Public Finance and Audit Act where that will benefit, and also to develop comprehensive guidelines as recommended in the PAC report.

But the changes to the Act and the new guidelines are only words. It's really your actions as management, that must bring internal audit into the situation where it is a valuable management tool which will help you to achieve excellence. You may need to redirect additional resources into the internal audit area. You may need to examine the cultural attitude towards internal audit within your organisation, and this may include the focus that your executives place on internal audit. So this morning's seminar is a joint activity involving myself as Treasurer, Treasury, Public Accounts Committee through its Chairman, Director and Members, and the Auditor General, and I hope that it gives you some idea of the importance with which Government regards internal audit.

Finally, please take advantage of this morning's opportunity to present your views on how we can best advance performance of internal audit in the New South Wales public sector. Thank you for this opportunity. Mr Chairman, thank you very much for inviting me this morning to participate in this extremely important program and I wish you well in your deliberations today.

## THE COMMITTEE'S REPORT

**Andrew Tink, MP, Chairman of the Public Accounts Committee**

Well it was excellent news this morning to hear about the Standard and Poor's rating. Some of you may be aware that the Public Account Committee is putting on another seminar in December on the financing of infrastructure projects, and we have the head of Standard and Poor's coming out from the United States. So it appears, with the benefit of hindsight, we have chosen well.

I would like to talk today about the Committee's report on *Internal Audit in the New South Wales Public Sector*, some of the feedback we have been getting since the report was tabled, and some of the developments that have occurred as late as yesterday in relation to where the Committee is going on this and where we see things at the moment.

Just on a brief recapping of the report itself, I guess there are a couple of aspects that stand out in terms of approach, and I think they deserve some sort of brief mention. I guess we see the heart of the report as being section 11 of the Public Finance and Audit Act, and our key recommendation is that internal auditing should become mandatory rather than be of a type which occurs "where practicable". We have taken the view that it is important to make a legislative statement about the importance of internal audit and that it ought to be mandatory. That, of course, means there will be some instances where internal audit is not appropriate because of the nature of the body concerned or the quantum of the turnover. Obviously, there will be a need for exceptions, and we have indicated that we think that Treasury has a role to play there, which

I understand they have taken up.

I guess one of the things that struck the Committee when we looked at all this, is that it was very hard in terms of any published material, to get an idea of who was doing what sort of internal audits, if any, where and when. There did not seem to be a great deal of material in many of the publications that government bodies put out about just what the level and nature of scope of internal audit was. That got us to the view that, first of all, there ought to be a clearly set out statutory proposal for internal audit, and that there ought to be some accountability mechanisms involved as well. One of the key accountability mechanisms, as we see it, is the annual reporting requirements which we have suggested. We found it very difficult to get a handle on looking at annual reports, just who was addressing internal audit and who wasn't, and if it was being addressed to what extent. We just really had no idea.

That led us into some errors, I might say, and we have apologised in the past for some of the conclusions we have reached about particular public sector agencies and their coverage of internal audit, but in our defence we did find it very hard to isolate where something which was in fact internal audit was perhaps not adequately identified as such in the annual report, at least to people like us on the outside looking in. That highlighted to us even more the need for there to be some sort of reporting which was absolutely clear that it was about internal audit, and that meant specific criteria.



Now the recommendations that we have made have been proposed to be varied slightly by Treasury on that score, and I think it is fair to say we accept the proposed changes. I guess we had in our mind that it was important to look at the reporting requirements in two stages. First of all to have some type of report about what internal audit had been up to in a particular year, but also to have a statement about what was planned by way of an internal audit program. This would enable anybody to look back and say, well, this is what was proposed by internal audit, and this is, in fact what happened during the year. You could then actually go through the press clippings down in the Parliamentary Library and see where the problems had been as reported in the press, and then actually compare the reality of what happened in the year against the audit plan for the same year, and get some idea of whether or not all, or some, or none, of the areas that in fact caused trouble were on the audit plan.

Now I think Treasury, quite rightly, has pointed out that there is a limit to the extent to which you want to do that in practice because you may be signalling your plan to a degree that is inappropriate if you are targeting areas where you don't want to give people advance warning that you are coming. So I think that we accept that there has to be a little bit of moderation to from what we were proposing in terms of setting out a plan in very concrete terms to a compromise where there is sufficient sense of direction contained in the report, but not one that necessarily flags all the problem areas so that the people proposed to be the subject of the audit get warned in an inappropriate fashion.

We particularly focused also on the question of fraud. Obviously, as you know, we have a strong on-going

relationship with the Auditor-General which, as far as the Committee is concerned, is of absolutely primary importance. He does not always agree with us. We don't always agree with him, but I think that is very important in any relationship of the type we have, that you call it like it is. But the point is, I think it is our statutory duty to read his reports very, very closely, and from a parliamentary context, to assist in the sort of issues that he raises.

Now I mention that in the context of the first report that he tabled in Parliament for 1993 where he expressed considerable concern about fraud and corruption prevention strategies and indicated that there was a liability to the State somewhere about a billion dollars in this area. So we took that up and made a particular point of stressing fraud and corruption prevention strategies in the context of writing it into the Act and writing it in the context, in particular, of internal audit. I think for that reason that deserves particular mention in the context of all the recommendations made.

Another issue is the question of the scope of internal audit. There was some debate in the Committee about the question of to what extent we emphasise fraud and corruption prevention on the basis that it might, in some way, emphasise the more traditional areas of internal audit at the expense of what we thought was a very important issue now of making internal audit more broad-based, more broad in scope. We gave some thought to the extent to which we should press the fraud issue, because it might send out the wrong signal about what we were saying with regard to broad-based internal audit, and indeed, that is exactly what happened. A couple of people took that up and said your question of scope is far too narrow because you are concentrating

on fraud. In fact, the President of the Australian Institute of Internal Auditors, Peter Willey, tackled me on that at one stage and suggested that the scope was too narrow. But after some discussion and consideration of the broad-based scope that we recommended, we clarified the point and they now support our report. But it was of concern to us that we might have been sending out the wrong message in talking about fraud and corruption prevention that we were, in fact, talking about a fairly narrow based scope for internal audit. That's not the case, but we believe that it is very important to also stress up-front the importance of fraud and corruption prevention in that context.

On the broad scope, as I have indicated before, I think that presents enormous challenges for internal auditors. I think it present individuals in organisations with great challenges. Broadly speaking, you are now moving to a situation where you are looking at economy and efficiency and effectiveness. As Professor Walker indicated in an article a little while back in the *New Accountant*, we have had a difference of opinion with the Auditor-General in relation to a special audit that he did on disciplined services and accommodation. The Committee's view was that that audit should have been more broad-based than it in fact was on the basis that it was said to be a special audit. Bob Walker's point was, well, if the Auditor-General has had sort of an introductory difficulty with the broad-based scope, it's going to make it exceptionally hard for internal auditors in public sector organisations.

We were very pleased to see as a Committee, with the *HomeFund* report that the Auditor-General did (and I know it's a controversial report and there are differences of opinion about many of the recommendations), was that he did

address those issues specifically of economy, efficiency and effectiveness, and we found that very useful. That report is a very relevant report to us as we look at infrastructure financing. We are very concerned about risk allocation and that whole line of inquiry. We found the Auditor-General's comments on the HomeFund structure and the problems that occurred, to be very, very valuable as far as our understanding of some of the pitfalls of things like Loan Council guidelines is concerned.

So the point I am making is we got a lot out of that *HomeFund* report because those three issues were addressed. To me, and I think to the rest of the Committee, that shows the potential for broad-based audits and a broad-based approach to internal auditing. But the challenges, I think, are just absolutely enormous within organisations as to how that's tackled, because you really are getting out of traditional areas that CEOs and senior management people in the organisations would normally expect you to be involved with. In the early days I think it will probably create a fair bit of tension.

The other thing is that in terms of interpersonal skills and all that sort of thing, it is going to be very hard work right throughout the organisation for internal auditors to be involved with a whole lot of people down the line looking at this much more broad-based scope type of internal audit.

I guess in terms of trying to put it all together and come to some view on how best to implement or create a climate where this change can be implemented, it seems to us that you keep coming back to the chief executive officer. If you look at section 11 of the Public Finance and Audit Act as it is currently drafted, there is a recognition there that the chief

executive officer has a role to play. I suppose what we tried to do in the report is to "up the ante" quite considerably on that, to quite deliberately put the chief executive officer right at the centre of the whole process. The reason we have done that is because we think it is the chief executive officer who has the authority and the control, and has the discretion over how the resources are deployed that will make or break an internal audit unit at the end of the day.

So if internal auditors having difficulty getting access to a particular part of an organisation, then the way through that log jam is through the CEO. I mean the CEO will make sure that whoever it is who is holding things up will make way for internal audit to come and have a look. We think the CEO is important in terms of deployment of staff. I mean you can reach a situation sometimes where internal auditors are deployed into other jobs that are not strictly to do with internal audit.

Again, at the end of the day it is the CEO who says to the human resources manager or whoever, "Look, these people are going to do internal audit. I don't want them being pulled off into management tasks."

Again, on the question of resources, it's ultimately the CEO who has the say within the organisation about the level of resources and the level of skills that are required to make up the personnel in the internal audit unit. If there's a problem there, then it seems that the CEO is in the position to prioritise it and sort it out.

So that is why we focus very much on the chief executive officer in terms of being the lynch pin about being responsible for all these recommendations, and to some extent, in

a symbolic sense we took the view that it ought to be written into the CEO's contract. I suppose in a strictly legal sense to some extent, that is superfluous because I think there are legal requirements already clearly under the Act which require the CEO, "wherever practicable", to have an internal audit function. It goes without saying that if it is not expressed in writing then it is implicit in any such contract that they are required to ensure that their organisation carries out its functions in accordance with the law. I mean, that is like night follows day. But we thought symbolically it was important to take it one step further and actually write it into the contract. Now that is a matter that Treasury alone is not in a position to take up. It's something, as I understand it, that has to also be taken up by the Premier's Department, but we do think that in a symbolic sense it is very, very important for that message to get through.

The other major issue is the question of some sort of oversight of internal audit, and we think it is very important that wherever there is a board, for there to be an audit committee of the board, for two main reasons. First of all, where there is a situation where indeed, the problem is the chief executive officer, and that can happen from time to time (I think it's very, very rare in the public sector but all too common in the private sector, although that's not to say it won't happen at some stage), there has to be somewhere for the internal audit person to go other than the chief executive officer. Now if there is a board of the organisation concerned, it just does seem they are really a ready basis for an audit committee, which at one at the same time is standing apart from senior management but still part of the organisation. I think the other thing that is important about such a committee is

that it can provide some guidance on audit plans and just provide again, whilst being broadly part of the organisation but still significantly independent of the day to day running of the organisation, some sort of dispassionate advice about audit planning, in conjunction with the chief executive officer and in conjunction with the internal audit manager.

We think that is very important. It's plainly the case that there is a very large number of public sector authorities, including some very large ones, which don't have a board. I suppose the next best thing is a committee made up of senior managers and maybe somebody from the Auditor-General's office in effect conducting the same sort of role. But it really at the end of the day is a series of checks and balances right throughout the organisation.

When it is all said and done, what we want to try and promote is a situation where problems are handled internally so they don't become problems out in the wider world. In that sense it really does just seem to us on the Committee that internal audit can sometimes be seen as being a thorn in the side of management, bringing issues up that perhaps might be seen in some sense as difficult, tricky, embarrassing, or whatever. I mean that if an issue *is* brought up within the organisation and can be dealt with early in time, which is what internal audit offers, then you are going to save yourself a lot of pain in tackling it early as distinct from letting it fester, or not knowing about it and having to face it in the form of a question without notice through your Minister in the House, or some headline in the newspaper, or some sort of referral to one of the statutory authorities. It is much better to get on to it early! In that sense I just think that internal audit properly running is a very, very important tool for management, and

something that ought to be seen right throughout the organisation as a plus and an ally of the organisation rather than as the enemy.

We have been continuing to look at the whole question of internal audit, and there are a couple of developments in recent times that I think are very interesting and touch, to some extent, on issues of broad-based internal audit, getting away from issues that relate specifically to record keeping and checking on balances and accounts and so forth.

Now the Police Service and the Independent Commission Against Corruption have put out a discussion paper through the Corruption Prevention Unit of the ICAC on the management of criminal investigation as a high risk area. I guess at times I have been critical of the Police and the ICAC for that matter, but can I just say that I think it is a really excellent report. As somebody who has an interest in police matters, an interest in the ICAC and an interest in internal audit, I have just found this whole report fascinating and a really good starting point for looking at the way in which criminal investigations are managed.

Now the chapter that really caught my eye was chapter 7, which talks about record keeping. It opens with a quote from the Police Commissioner's circular of the 9 August 1993 which says, "The security of publications created by members of the Police Service is of critical importance to the efficiency and credibility of the Police Service." Then there is a whole section which deals with record keeping in relation to the Police. I think that indicates that (and I don't think it's probably any different in most public sector organisations, but perhaps of primary importance with the Police, the



Ombudsman and the ICAC) this sort of thing is fundamental to successful criminal investigations. I think one of the points we have been trying to make in the *Internal Audit* report is that when you get away from financial management to some of the broader issues, internal audit in relation to things such as record keeping, we think, has a crucially important role to play. I guess that would also be particularly true of the Department of Corrective Services as well.

There was an unfortunate incident earlier in the week, and these things happen from time to time, but I guess at the end of the day there is nothing of more fundamental importance when you are taking away the liberty of people you have people incarcerated, to make sure that your records in relation to them are right in relation to the sentence they are serving and so forth. I mean, just for example, hypothetically speaking, and I don't think it's happened, if you have a situation where somebody was in gaol or kept in gaol for longer than their designated sentence because there was something wrong with the records, then it seems to me you have an absolutely fundamental problem that strikes at the heart of what the whole State is about when it comes to law and order and punishment. So, record keeping in that sense is crucial.

Now to my mind that is getting a fair way away from traditional internal audit. They get into some very, very significant liabilities and arrangements, and I think it is just inherently very, very hard to keep control from an internal audit point of view whether it be in the Health Department or in universities on those sorts of issues.

These days the public sector has changed. It is now big business and must be run as a business.

We have, I guess, made two suggestions to try and deal with this. As far as the Health Department is concerned, we just came to the view that it was unrealistic to hold Dr Amos or whoever his successor might be, personally responsible for all internal audit in the Health Department. It just seemed to us to be an unreasonable thing to do. We came to the view that for financial reporting purposes there had to be some sort of splitting up of responsibility within the Health Department, so that you got some down-the-line responsibility with discrete management units where you could appropriately and properly say there is a CEO for an area. The buck ought to stop there for the purposes of that area, rather than sort of all finally channel up into the Health Department headquarters.

But the corollary of that is that something would have to be done to reorganise the reporting arrangements and the legal responsibilities to ensure that the CEO of the area was able to be considered so lawfully. I think Treasury has taken a slightly different approach to us on that. I know there is some movement on that front, and I guess it is important to try and be realistic when you are dealing with something as complicated and as expensive as health, to not have it all end up on the CEO's desk of the whole operation if the practical reality is that there is no way they can get a handle around the particular accountability issues in every area health service in New South Wales. Putting that in context, I think the Central Sydney Area Health Service is larger than most departments in its own right. That's probably a pretty good call on its own I think, for accountability.

As far as universities go, we just took the view that if they are going to stay within the State arena when it comes to control, then we did not see any good reason why it should not be subject to the Treasurer's Directions, and we found it interesting that they were not. If, in fact, they become more of a Commonwealth responsibility, then it will move out of our range altogether. I think the Treasury view on that is that we will just wait to see what happens as far as the future of universities is concerned, in terms of their accountability, before taking up that question. But if they do remain a substantial responsibility of the State of New South Wales, then they ought to come under Treasury directions.

Just in conclusion, it has been interesting to us to follow the Olympic debate. We put out our Annual Report last night and I notice the Auditor-General down the front there. He's not going to be too happy with this, I suspect; having lectured everybody on annual reports. We have broken a few rules and taken a leaf out of Jeffrey Archer's book, and put some of the endorsements on the back cover. I don't know whether that is appropriate for annual reports, but anyway, that is what we have done. But in the context of that Annual Report, we have made a point that we think the fact that the Sydney Organising Committee for the Olympic Games is going to be a statutory body and come fully under the auspices of the Public Finance Act, the Auditor-General, the ICAC, the Ombudsman and Freedom of Information legislation, is a good thing, a very good thing, and gets us off on the right foot in terms of the sort of accountability that is going to be required for a multi-billion dollar exercise.

But what this also means is that there will be a significant internal audit

responsibility placed on the Chief Executive of that Olympic Games Committee, whoever he or she may be. I think it is very important that that happens, and that the Committee also be made subject to the special audit provisions in the Public Finance and Audit Act, and from time to time subject to some broad-based special audits. So I think some of the things we have been doing in relation to this report are hopefully going to be useful, and in relation to the single biggest risk exercise that we are embarking on between now and the time the Olympic Games come around in the year 2000, internal audit will hopefully play a positive role in the way in which that is organised. Internal audit is not in many senses, certainly as far as the press is concerned, the most exciting topic in the world—I have discovered that—but it is nevertheless of fundamental importance. If I could put it this way—whilst internal audit may not be all that exciting to them, the sort of problems that occur if internal audit is not working properly are of the greatest excitement to them, and will therefore, by definition, be the greatest embarrassment to anybody who is on the wrong side of the problem.

In conclusion, can I just thank all the Public Accounts Committee members and the Director. We put a great deal of effort into trying to work in a bipartisan fashion. Now some people say that means that you end up with reports that sometimes are not all that exciting. I have some very strong views on this. We are in an organisation up there that take up about half a million dollars worth of taxpayers' money every year, give or take a few dollars here and there, and I think that we only do anything that is useful or only add any value, if you like, if we come up with a result which is a little bit different to the result you get in Parliament. Now if we wanted to simply

call the issues as we see them respectively on each side of the House, then we might as well go down in the Chamber and do it, because that is what goes on in the Chamber ad nauseam, day in and day out. I think that we only justify ourselves and do anything worthwhile if we can get together and come to grips with issues which add something because we all agree on it.

Now what that means, I suppose, is that sometimes some of the things we do lack a controversial edge; but a controversial edge usually comes if there is dissent within the Committee, and so whilst that is topical, at the end of the day I think means a bit of give and take around the place, where we trade backwards and all members of the Committee—Liberal, Labor and National—for being able to do that and be able to put some of their personal agendas away and just come together on issues of importance. It does not happen all that often around here.

We had one break-out over the Port Macquarie Hospital exercise which is not something I particularly want to do again. It was a hot potato given to us by forwards in ideas and are prepared to we do put tremendous effort in to try to you find, nine times out of ten, it does not in fact, advance the cause at all. So reach agreement on things, and that all drop off on particular things to get an agreed result. I just wanted to close on that point and particularly congratulate the Parliament, but it just underlined to me the real problems that you have when you get into an issue where there is no consensus nor a likelihood of consensus—we don't add anything at all. Therefore we put a real emphasis on trying to get an agreed result, and I just want to congratulate the Committee for all the work they put into getting that. Thanks very much.

## **THE NSW TREASURY RESPONSE**

**Bob Scullion, Assistant Secretary, NSW Treasury**

Good morning everyone. Thanks for this opportunity to discuss with you the response from the Treasurer to the Report of the Public Accounts Committee. I really would like to start by saying that this is an absolutely excellent report which, when its recommendations as listed in appendix 2 are implemented, will set an appropriate and relevant framework for internal audit in the New South Wales public sector for the foreseeable future. There are some 45 recommendations, and I did try to think of some logical way of dealing with them, or perhaps grouping them. However in the end it seemed to me that the simplest way to respond might be to deal with them numerically, except that those very important recommendations dealing with the need for legislative change I would like to mention first.

Recommendations 16, 17, 18 and 19 all deal with legislative change. Recommendation 16 deals with strengthening the extensive requirement for internal audit and No. 17 establishes a criteria for applications for exemptions from internal audit: 18 imposes on Treasury a duty to maintain a schedule of exemptions, and 19 provides for the Auditor-General to review those agencies who have been scheduled for exemption. In relation to the major change in Recommendation 16, Treasury fully supports the proposal, but in relation to exemptions, we don't really think it will be necessary to have a separate schedule of exemptions, as annual reports legislation already requires all exemptions granted by the Treasurer to be listed. However, apart from that, the broad contents of these recommendations will be implemented. I would have to say

from a personal viewpoint the organisations which do not require some form of internal audit would be certainly few and far between.

The other point I would like to make about legislative changes and in the initial response from the Treasurer to the PAC, we indicated that we would try and undertake the legislative change during the current review of the Public Finance and Audit Act which is scheduled to be completed in September 1994. But with the wisdom of a little bit of hindsight and recognition of the importance of these legislative changes, we have decided to adopt a slightly different attitude. We will be putting a minute to Cabinet shortly and we would hope to introduce these legislative changes during the Autumn session of Parliament. So we certainly think that they are important and we ought to get on with it.

In the very first recommendation the Committee proposes that the Treasurer should list the area health services, the Ambulance Service and the proposed country-based regional health services separately as statutory bodies. Treasury itself is in broad agreement with this proposal and that is one of the matters we are examining in the context of the comprehensive review of the Public Finance and Audit Act. As most of you would know, we have a working party which is carrying out this review, and we have the Auditor-General personally on that working party. We have someone from the Treasurer's office, people from the Office of Public Management, Parliamentary Counsel's office and from major line agencies. We are certainly not working in isolation on the issues.



Development of national standards for public sector internal auditing is covered in Recommendations 2, 3, 4 and 5, and basically the Committee is proposing the development of these national standards in liaison with the major accounting bodies, the Institute of Internal Auditors and the Standards Association of Australia.

We certainly agree with that proposal and we will be initiating some action in conjunction with the Auditor-General. However, I think we have to recognise the practical difficulties in trying to develop national standards. This will mean that we will have to have involvement with the Commonwealth Department of Finance, the State Treasuries or Departments of Finance, and all the other jurisdictions and other Auditor-Generals' offices throughout Australia, so it is going to be a complex project partially because of the large number of interested players. Standards are unlikely to be developed on a national basis within a short period of time, and of course, like all of you, we are certainly subject to a certain degree of resource constraint in the amount of effort that we can put in to developing these standards.

As an interim measure, the Committee has proposed that we should adapt the internal audit standards developed by the Commonwealth Government and issue them as Treasurer's Directions, and we are happy to accept that recommendation. But before doing so, we will be seeking input from the Audit Office, from the Internal Audit Bureau, the Premier's Department, ICAC, from the Ombudsman, and of course, we will also be seeking input from the line agencies, and in doing so we will cater for the provision of Recommendation 4 which deals with the working

relationship of internal audit with the review agencies.

Recommendation 5 proposes legislative provision for compliance with the standards. That proposal is also accepted, and we will include that with our legislative review which, as I said, we hope to introduce in the Autumn session.

In Recommendation 6 the Committee has suggested that my part of Treasury—the Office of Financial Management—should include in its annual report a section on what it has done to ensure compliance with the internal audit standards and an evaluation of that compliance. We accept that proposal in part. It seems to me that it would probably be more logical for the Auditor-General to evaluate compliance with standards and we will be talking to Tony Harris, the Auditor-General, on this matter. We would propose that if the Auditor-General undertakes such a review he will report to the Treasurer on any breaches of prescribed requirements which are sufficiently significant.

The question of universities, as Andrew said earlier is complex, universities should not be exempt from Treasurer's Directions while they are administered by the State. We all know the situation with universities in relation to funding, and our response to this issue is that we are going to try and communicate with the Commonwealth Department of Education, Employment and Training, to try and determine what is the Commonwealth long-term intention with regard to the control and accountability of the universities. But if Commonwealth control is not effected by the time the Public Finance and Audit Act is replaced, we will certainly be giving very close consideration to removing that present dispensation under which the universities do not have to comply with the Treasurer's Directions.

The Committee has suggested in Recommendation 8 that we should establish an advisory group comprising representatives of the professional, accounting and auditing bodies, the Standards Association, the Auditor-General and some large government agencies.

At present we already have an advisory group in existence which is known as the Treasurer's Accounting Advisory Panel. This group is composed of senior partners from the big six accounting firms, Tony Harris is represented by one of his Assistant Auditors-General, and we have an academic from Sydney University on the panel. We tend to feel that rather than establish another advisory panel, we should extend the terms of reference of the present panel to cover internal audit issues as well, and we are very confident that, particularly from the big six firms, the quality of the advice we can receive is very high. However, we will also seek advice from the Auditing Standards Board of the joint accounting bodies, from the Internal Audit Bureau, and of course from the Institute of Internal Auditors, and once again, from the agencies. We certainly intend to do a fair degree of consultation.

Obviously, with the introduction of legislative change and the development of internal audit standards, the existing internal audit guidelines which Treasury issued will need revision. That has been recommended by the Committee in Recommendation 9 and we certainly accept that.

Recommendation 10 places a requirement on the Auditor-General to report to Parliament on the adequacy or otherwise of the standards and guidelines that Treasury develops, and the actual performance of internal audit in the New South Wales public sector. Treasury

accepts that proposal in principle, but obviously we need to consult further with the Auditor-General on how that would best be implemented. I should add that it is not uncommon for the Auditor-General in his report to Parliament already to comment on the effect and efficiency of the internal audit activities of agencies.

As has been mentioned, very sensibly the Committee recommends that fraud and corruption prevention strategies and systems should be made a top priority for review by internal audit and that the Treasurer should legislate accordingly. We accept that proposal and we are going to make some appropriate amendments to the definition of internal audit in the Act to specifically cover the audit of fraud and corruption prevention strategies in systems. I am sure you are already all aware that both the Auditor-General's office and the Office of Public Management are currently in the process of developing fraud control strategies and related internal control and audit procedures for uniform adoption by all agencies in New South Wales

Recommendation 12 states that the current requirements for agencies to prepare accounting manuals in terms of the Public Finance and Audit Act is narrow, and it recommends that the Treasurer amend the legislation to expand the requirements for an accounting manual to include manuals covering accounting policy and procedures, internal control procedures, both financial and non-financial, and internal audit.

Once again, Treasury is in agreement with this recommendation. Although the term "accounting manual" is used in the legislation, the intention is that the manual should at least cover accounting and internal control matters. As one outcome of the review of the existing

legislation, Treasury actually hopes to replace the existing Treasurer's Direction with statements of best practice to get away from the prescriptive requirements we have at the moment. These statements of best practice will consist of broad principles to be followed by agencies with respect to the various elements of the new financial and resource management framework that has been put in place in New South Wales. Matters relating to accounting policies, internal control and internal audit will be specifically covered in the statements of best practice. The intention is for you, for each agency, to develop its own detailed policies and procedures based on the broad principles set out in the statements.

Recommendation 13 asks us to develop guidelines for chief executive officers on items to be included in the manuals referred to in the previous recommendation. The Treasury also accepts this proposal.

Recommendation 14 correctly states that chief executive officers of agencies must set in place appropriate internal controls covering *all* parts and operations of their agencies, so it is certainly wider than financial. Treasury accepts that the legislation should remove any doubt concerning that requirement.

Accountability is always important, and Recommendation 15 suggests that the performance agreements of chief executive officers should include effective internal control as a key of accountability with appropriate performance indicators and performance targets. We view that proposal as one that has merit, but as Mr Tink mentioned a little earlier, it is not within our purview. So we have written already to the Premier's Department which, as you know, is responsible for general policies

relating to performance agreements, and we have sought some input from them.

Recommendations 20 and 21 are concerned with the form which internal audit services may take.

Recommendation 20 says that where internal audit is being contracted in, then chief executive officers should use the Office of Public Management's guidelines for the engagement and use of consultants in selecting and managing the internal audit service. Treasury certainly fully agrees with that.

In relation to Recommendation 21, which stipulates that the organisational form of the audit function should be left to the discretion of management, this again is a situation where Treasury is in agreement. The future guidelines that we issue will give advice on this matter, but it is certainly not considered appropriate to specify the details of administrative arrangements in the legislation.

In Recommendation 22 the Committee requires the internal audit charter to include a positive statement on internal audit capabilities indicating that all accountability issues are addressed. Where services are contracted in, the capability statement should include how co-ordination of total internal audit coverage is achieved. Once again, we fully agree with this recommendation and we will certainly make sure that that is covered in the guidelines.

The broad scope of internal audit that is appropriate to the public sector is included in Recommendation 23, which indicates that it should cover information technology audits, efficiency and effectiveness audits, compliance audits, and control and prevention of fraud and corruption. We agree with this recommendation and with the statement that internal audit needs to be involved

with new information technology developments from an early stage. In fact, at the moment, Treasury itself is undertaking a major IT development for our internal systems in relation to our accounting and budget monitoring, and we have involved both internal and external audit from the outset.

As part of Recommendation 24, the Committee says that internal audit should be given a free rein to examine any area that, in the professional opinion of the audit manager, warrants attention. Treasury's view is that internal audit is part of the organisation and is accountable to the chief executive officer, and the audit charter and audit plan should therefore be subject to the chief executive officer's approval. But once approval has been given, we certainly agree that internal audit should be allowed to conduct the audit in accordance with generally accepted auditing standards and practice without undue interference from management.

The next recommendation deals with the need for continuing professional development of internal auditors. Treasury agrees with the Committee's recommendations, and once again we will include in the guidelines some indication of the requirement of the chief executive officers where they have an in-house internal audit unit and they are not contracting the service in, to provide some sort of explicit budget for ongoing training and education of audit staff.

No. 26 deals with the need for internal audit independence from the operations of an agency. It is very obvious that conflicts of interest must be avoided at all costs. The internal audit guidelines will provide that staff seconded to internal audit should not audit the areas in the agency from which they originated.

Recommendation 27, which Treasury once again freely accepts, proposes that the guidelines should recommend to chief executive officers that they should review the quality of internal audit through questionnaires to management.

The next recommendation also has a relationship to independence and deals with situations where staff of the Auditor-General could be perceived to be playing a dual role in both external and internal audit. Treasury has written to the Auditor-General and the Director of the Internal Audit Bureau for advice, and the outcome of those letters will be discussed with the Public Accounts Committee.

The following Recommendation No. 29 is, in effect, similar in nature in that it says it is generally inappropriate for both the internal audit and external audit of an agency to be conducted by the same auditor. The Treasury accepts the proposal but we recognise, as does the Committee, that there may be exceptional circumstances such as those relevant to the Independent Commission Against Corruption.

Recommendation 30 is quite important in my view. The Committee points out that many chief executive officers have failed to ensure that their internal audit unit reports directly to the CEO as is required by the existing legislation. The Committee has proposed that the legislation should be amended to have CEOs specify the appropriate reporting lines in their annual report. Treasury certainly fully supports the need for internal audit to have direct access to the chief executive and to report to the chief executive, and new internal audit guidelines are going to cover that issue.

Recommendation 31 is dealing with what should be in your annual report. The

Committee recommends that an agency's annual report include a section on internal audit covering the program of internal audit planned for the year under review, the internal audit functions contracted out and conducted in-house, major findings of the audit and other significant matters relating to reviews of internal control, major internal audit recommendations and management's response including reasons for not implementing recommendations, problems experienced in conducting the planned audit, the audit plan for the following year, and details of exemption from internal audit if that is applicable.

I have to say that Treasury probably has some concern at the amount of detail already required to be disclosed in annual report as a result of a large number of amendments made to the regulations in recent years. However, it is intended that we amend the regulations to make a specific reference to internal audit and to acquire the disclosure in respect of all internal audits conducted during the year of:

brief outline of the major areas or activities that have been audited, significant problems or issues that have been identified by audit, and the actions taken, or proposed to be taken, by management, major initiatives taken to improve internal control and internal audit, and a brief outline of the audit plan for the following year.

From a personal perspective I have some reservations, as Mr Tink mentioned earlier, about outlining of detail the audit plan for the ensuing year, as I think it would be difficult for chief executives to do this as they may not necessarily wish that the areas about to be audited to know about it too far in advance.

The Committee proposes, in Recommendation 32, that compliance with annual reporting by chief executive

officers on internal audit and significant matters raised by the Auditor-General should be policed by Treasury. We accept that proposal and we will be monitoring compliance of annual reporting as part of our Annual Report's Examination Program. This program is conducted jointly with the Auditor-General's Office which acts as our agent. I should mention that a large sample of annual reports are reviewed each year and all deficiencies identified are raised directly with chief executive officers of the agencies concerned.

Recommendations 33 and 34 seek to further strengthen the independence of the internal audit by ensuring that there is no ongoing line management or other operational responsibilities placed upon internal audit, and also stresses that an internal audit section should not be used as a pool of staff to fill temporary vacancies in the agency. Treasury accepts both these proposals and will ensure they are dealt with in the new guidelines.

Recommendations 35 to 38 deal with audit committees. James Guthrie is going to say a few words about audit committees a little later, but these recommendations talk about their formation, membership and role. The final recommendation in this group also requires that the Auditor-General should review the functioning of audit committees in executive audit committees and present his findings in his annual report to Parliament.

Treasury supports all those proposals, and in relation to the last mentioned one we have written to the Auditor-General seeking his views as to how it could best be implemented. It may not be, for example, necessary to conduct an annual review of all such committees, and of course, if such a review was conducted



annually there may be extra audit fees placed upon you as agencies, and it would certainly have resource implications for the Auditor-General's Office.

No. 39 suggests that the guidelines need to include an explanation of the detailed process required to prepare an effective plan for the conduct of internal audit functions and to show how his planning process should be used by management to assist in determining the appropriate resources required for the internal audit function. This is a very sensible approach. We agree with that and that will be included also in the guidelines.

In Recommendation 40 the Committee proposes that the standards to be adapted in accordance with Recommendation 3 should incorporate Statement of Auditing Practice AUP-10 *Planning*, suitably augmented to include the broad scope and objectives of internal audit to assist internal audit managers with the planning process. Once again, we agree with that proposal.

The whole aspect of reporting of internal audit is very important, and it's really incumbent upon the chief executive and senior executive of agencies to ensure that the reports that you get from internal audit are the type of reports that you want. It shouldn't just be left in the hands of the internal auditor. It does remind me of the story of the internal auditor who died. This particular internal auditor had not been a very effective internal auditor in his life on the earth, but he appeared before the pearly gates, and to his surprise an angel came out to greet him and the angel said, "would you like to go to heaven or to hell?" He said, "Goodness gracious, I didn't expect to have a choice," and the angel said, "Well, perhaps if I could show you a little of each it will assist you in making

your choice". So he said, "Great, great idea!" The angel led him down a path and they came to a magnificent beach, golden sands, blue waters, sun bronzed people playing volleyball, even a little bar up at the end. The internal auditor looked at it and said, "My goodness, I never thought heaven would be like this," and the angel said, "That's not heaven, that's hell". He said "Well, you better show me heaven". So they went a little further down the path and came to a rather ordinary looking park and there were some people there feeding the pigeons and playing bingo, and the angel said, "This is heaven." The auditor smiled gently and said, "Well, I'll take hell," and immediately he found himself ensconced up to the neck in red hot lava, and there were little devils poking him with red hot irons. In amongst his shrieks of agony he screamed to the angel, "What happened to the beach and the volleyball?" The angel said, "I am sorry, but that was only the draft report."

As part of the standards for internal audit, the Committee has recommended in Recommendation 42 the introduction of quality assurance programs including three yearly external reviews in line with the internal audit standards issued by the Institute of Internal Auditors. Treasury supports the proposal in principle and we have written to the Auditor-General to seek his views on the implementation. From the Treasury viewpoint it seems there would be distinct cost advantages if such reviews are conducted by the Auditor-General, but when his response is received we will enter into further consultation with the Public Accounts Committee.

Recommendation 43 is specific to the operations of the Internal Audit Bureau and that Recommendation proposes statutory peer reviews similar to that

which take place in the Auditor-General's Office. It is difficult to make a direct comparison between the Auditor-General's Office and the Internal Audit Bureau. One has a monopoly over the annual audits of agencies and the other competes for its business in a fully competitive market. It is Treasury's view that a peer review should be a recommended practice rather than a mandatory requirement. Of course, the reality is that the Bureau may well decide to have such reviews undertaken in any case as part of its guarantee of service to clients.

Finally, Recommendations 44 and 45 provide that in-house internal audit units should have appropriate qualifications or be working towards them, and Treasury should develop competency standards for internal audit staff in the public sector. We certainly agree with both those proposals and we will certainly endeavour to address the issue of competency standards as we are currently doing in relation to accounting and finance offices in the public sector generally. However, as I mentioned earlier, the development of standards has national implications and that makes it difficult to achieve anything in the short term.

I would like to conclude by stressing to you the importance of the function of internal audit. As the Treasurer mentioned earlier, the topic surely must have some importance when it can bring together the Treasurer of the State, the Auditor-General, the Chairman of the Public Accounts Committee, the Treasury and senior officers of line agencies. Internal audit is a review mechanism which really can be a wonderful value to you, but for this to happen chief executives must give internal audit the independence, the resources and most importantly, the

support that it warrants. I must say it causes me concern when I see in small organisations so-called internal audit units which consist of a single person or two people. I have no idea how the chief executive in those organisations satisfies himself or herself that adequate coverage is maintained.

Finally, it is very satisfying from a bureaucrat's viewpoint, to receive a report from the Public Accounts Committee which contains a very large number of recommendations and to find that Treasury is able to support over 95% of the recommendations, and with the balance there is a difference of opinion only at the margin or because there is a requirement to consult with somebody else before implementation. Thank you very much.

## **THE AUDIT PERSPECTIVE—AUDIT OFFICE APPROACH TO INTERNAL AUDIT**

**Tony Harris, Auditor-General**

Well, it is about 51 weeks ago that I was standing here talking about internal audit with the PAC and Mr McGuinness and Mr Kropp. And some months after that the PAC brought down its report in June, and less than six months after that we have seen in Parliament, literally, perhaps not metaphorically, a government response to the PAC report. And I think the PAC should be gratified that the Government has responded so quickly to its report—there are many other reports from parliamentary committees that have not as yet enjoyed a government response. I suppose that, in some sense, is an efficiency and effectiveness test, isn't it? Does the Government respond? And of course, I will reiterate Patricia's views that the Government's response has been quite full. We made our response in Volume II of the Auditor-General's report for 1993, and I won't go through that again, but we did address there each recommendation, I think bar one, that concerned the Auditor-General or the Auditor-General's Office with respect to the PAC's recommendations.

Rather than go through those items, item by item, I wanted firstly to welcome the opportunity to speak to you and to the Chairman and the members of the PAC and ask a basic question, and that is, why do we have internal audit? In some senses when we are looking at resources and the application of resources, that should be, I suppose, the first question, why do we have internal audit? I suppose I can think of three reasonably simple answers: one, if you have an effective internal audit you will reduce your external audit bill, and I suppose that one

should seize the imagination and attention of all managers who are concerned about resources.

A second reason I think, is that the public sector in New South Wales is going through at the moment very radical changes, and I don't believe that those changes are going to be less radical in the years ahead. We are seeing in the economy a continuing pressure on resources and resource flows, and governments of all persuasions are under intense examination as to the effectiveness and efficiency with which they use those resources. So accordingly, managers are under intense pressure and are involved in an intense series of change, and while they have that intense series of change, it is very easy to avoid important issues. It is very easy for the urgent to drive out the important. Under those circumstances it is sensible to devote resources so that they may stand aside, so that they may look at the forest rather than the trees, so that they may help management ensure that its own systems and arrangements are producing the results that are expected and protecting the agency from fraud and other misdemeanours.

There is a third reason and that relates, I think, to the current drive towards devolution and decentralisation. That does mean, and there are many examples in the public sector, that you are giving autonomy and responsibility to smaller and smaller units, and your systems may not be as centralised as they once were. And under that purview you are also running a risk, a managerial risk, about the adherence of these disparate,

regional, autonomous bodies, and their adherence to the corporation's rules and the corporation's systems and the corporation's procedures. So, for three reasons there, for those of you, and I know there are some CEOs in the audience, please bring that thinking to bear when you are looking at the resourcing and display of your internal audit.

Now for those of you who are internal auditors, I suppose it might be useful to go back and write a short minute to your CEO about the outcome of the seminar here today and obviously, reinforce the PAC's recommendations, but also bring to their attention in a way that doesn't look like self-pleading, the reasons why internal audit is important.

Amongst the other things I wanted to say is that the PAC report, in some sense, allows us another opportunity towards increasing the professionalism towards internal audit. This is in line with developments that I have seen subsequently in both Canada and Western Australia where the Canadian and Western Australian Auditors-General have reported on internal audit. In the speech you have a copy of the developments of the Western Australian trend in internal auditing, but I wanted to draw orally your attention to the Canadian developments.

It is certainly true in Canada, according to that Auditor-General, that internal audit is looking towards a more risk based plan in the internal audit process. Now that is a subject, of course, that is very much to the heart of the external audit because we run risk based auditing, and for that purpose it seems sensible for internal audit and external audit to work more closely together than hitherto about the scope of each other's plans. To assist in that we have started to see internal

auditors participating in the training courses that we, and others on our behalf, conduct for our own staff, and it is gratifying to see that internal auditors are coming to our own training course. It might mean that we are all making the same mistake if our training courses are not well run, but essentially it means that we are talking the same language. That's very important because if we try to gel together the plans and resources that we are applying, they will be for the same purpose.

The second important issue that the Canadian Auditor-General identified was that internal audit had to have an increasing solid relationship with senior management and boards, and this issue was comprehensively covered in the PAC report. There have been boards of major institutions which have been left in the dark about important management issues. I remember speaking to a board member the other day who pointed out that his agency had actually been taken to court, they had lost the case, and they had provided the remedy, and the board still was not informed by management of this occurrence. Now there is something more fundamentally wrong with that relationship than internal audit can repair, but nevertheless we have seen internal audit committees of the board which have been dominated by the chief executive, and I suppose a board committee ought not allow that kind of domination if it is going to hold management accountable to the board for the management's use of resources.

Now the idea of an audit committee of the board, the idea of an executive committee of the board, and the display of relationships within those arrangements, are covered within the PAC report. It is interesting to see that some large agencies are already adopting

the PAC's recommendations to improve their audit committee arrangements.

Another issue that the Canadian Auditor-General introduced as a trend is that the internal audit is now being seen as a place for the brightest—not a place for the slowest, but a place for the brightest. In some senses that makes sense, because if a CEO is looking to train senior executives, then it seems that a stint in the internal audit arena would be mandatory. Certainly you would wish also for senior executives to have some line experience at some stage, but internal audit will allow a person to have a grasp of the enterprise and the problems facing the enterprise and the goals that are before the enterprise in a way that would not easily be replicated for similar levels elsewhere in an organisation. Of course, to have the brightest people in internal audit is of great benefit to *us*. Again, it allows the external audit report to be much more effective if we can rely sensibly on additional resources displayed by internal audit.

The last issue that the Canadian Auditor-General talked about was technology, and we are seeing this more and more in our own office. I suppose within a decade we are going to see 90% of the audit work is going to be done by computers. Computer literate internal auditors on the systems side of an organisation's work are becoming more and more important, and indeed, those staff are becoming, I think, harder and harder to find, at least at the rates that are allowable in the public sector.

Now some other issues I wanted to talk about as touched on in the PAC report related to the independence of the internal audit. As Bob Scullion correctly points out, the internal auditor is part of the management resources, and while

there is a nice interesting relationship between internal audit and the board, the board should be careful to ensure that relationship does not undermine the management responsibilities that belong between the CEO and the internal auditor. I suppose it's best done as I have said before, in organisations like Pacific Power, where its audit committee has no executives on it as members, although obviously the executive director may be invited to sit on the internal committee of the board. The first group that the audit committee meets is the external auditor in order to determine how the "ship of state" is being run. The next group that the audit committee meets is the internal auditor in order to hear from the internal auditor how the progress is through the audit plan and what problems have been identified. The third group that comes into the audit committee is the executives' representatives, including the executive director.

Now that's a subtle way of ensuring that the board can use the resources of external and internal audit to satisfy itself as to its responsibilities, and at the same time in a way that does not undermine directly, explicitly, or even much at all, the relationship between the management and the internal auditor. It's something that I have seen work well in a number of agencies and it's something which I think agencies are looking at quite closely. But this question of independence does not just rest with the reporting chain. It does rest with the willingness of internal audit to tell it as it is. Now I have said before that we will always look at areas where internal audit has been prevented from looking, so if there is a "no go" area and we are aware of it, they will be the first area we will examine in our external audit. It was a year ago that we were talking about Tricontinental and its "no go" areas in



which directions were followed not only by the internal auditor but also by the external auditor because they were the same person.

There is another issue, and it is our willingness to look at the papers and the work done by internal audit so as to satisfy ourselves that all the issues that internal audit should have examined, have been examined. There is a further issue as well, and that is that internal audit should be able to communicate with external audit in a professional relationship way in regard to the issues that the internal audit section believes should be addressed to the external auditor. There ought not be any management interference in that relationship. If there is management interference in the communication between internal audit and external audit, then there is a problem. It is a very serious problem, the dimensions of which we don't quite know. It might be that the manager does not trust the internal auditor, which is a problem. Of course, the management should have remedied that as soon as the problem arose, but if that's the problem, it's not good enough to say well, it's because we don't trust them. That is a problem that management has not solved, so internal auditors ought to be able to communicate with us at any time on any subject. But more interestingly, internal auditors do have a professional obligation to bring to our attention the issues which they themselves are incapable of resolving for one reason or another, and this is an ethical issue, and a moral and professional issue.

Now I have been canned recently by the financial market for introducing morals into one of my reports. In the report on HomeFund I said that the investors in FANMAC Securities had a moral obligation with respect to helping to

remedy the problem. The Committee has this stinging response from an important investment underwriter saying that the word "morality" doesn't mean anything: "What are you talking about—morality? The finance market doesn't work on morality. It works on interest rates, dollars." Now it is an issue which I think is worth addressing reasonably seriously, but not in this context, of course, other than to say that it is not only CEOs that have a moral responsibility towards the management of resources—it's also the internal audit, and that requires a reasonably good personal relationship between the external auditor and the internal auditor.

We have in the past, I think it is fair to say, regarded internal audit with some suspicion. Now the suspicion rests on a number of issues. The suspicion rests on the fact that if internal audit does its job properly then there will be less work for external audit to do. We no longer regard that as an issue. There is considerably more work in accountability in New South Wales than we have the resources to undertake. I don't regard internal audit properly undertaken as any sort of threat, whether it is undertaken by staff of the enterprise itself, or whether it is undertaken by external consultants. Indeed, I am happy to say, that in a number of important audits we would have had to undertake more work but for the work of the internal audit. I am pleased that we can rely on the work of the internal audit in areas such as the Super Board, Pacific Power, and many, many institutions, including TAFE, in order to complete our work satisfactorily. It is not now an issue.

The second thing I would like to say about the scope of internal audit is that if one looks at the legislation it is broader than financial. Now we have recently acquired the mandate from the

amendment in the 1992 amendment Bills to examine efficiency, effectiveness, economy and compliance as it relates to any program of any agency that we audit. As you know, we are slowly developing that program that now occupies about 7% of our resources. But interestingly, I think, if you look at the internal audit, it's not just a mandate, it's a requirement under the Act. It also ought to look at efficiency and effectiveness issues relating to programs being run by those organisations. What is more interesting, if we undertook an audit of internal audit's progress in that area, I think we would find more failures than successes. It is something that I think you, as CEOs or as internal auditors, ought to have a reasonably good look at.

I can't, and never will be in a position to analyse the effectiveness, efficiency, economy and compliance of all programs in all agencies in the New South Wales Government, but I would like to see some structured effort by internal audit in that arena in the coming years. At some stage I will be very tempted and will look at how internal audit is reviewing that mandate, because it seems to me that is a reasonably important area for review. I don't mean by that that internal audit has to examine effectiveness and efficiency, but it ought to see what the agency is doing in terms of examining effectiveness and efficiency, and some of it is quite sensitive. If you look at prisons, for example, what's the effectiveness, efficiency, economy and compliance of prisons? The Chairman spoke about this a little this morning. Then look at the obligations we are imposing on the private sector who run prisons. We've worked out what those obligations are in some States, and we can apply those to our own institutions. Indeed, find out whether we're even measuring them,

whether we are imposing on ourselves the same discipline we are imposing on those whom we contract to undertake the task.

There is another matter I wanted to raise—there are two issues in fact. One is: under what circumstances do we take on the work of the internal auditor? My paper addresses that. Firstly the internal audit unit has to be considered to be a relevant part of the management of the organisation. It has to be given respect and held in some esteem. It has to be resourced adequately with, if not brightest in the organisation, people skilled adequately to do the task and I suppose, in some senses, that is what many of the PAC's recommendations were addressing.

Secondly, we would like you to undertake your internal audit on matters as they relate to the financial statements in a similar way to that which we undertake, in a way we can understand and thus, we do have to work reasonably closely together. It's no good doing half a job, for example, on non-current assets requiring us to come along and do the whole job again. If you are going to be involved, let us sit down and work out whether you are going to do it well enough for us in the first instance, and if not, then do some other work that is relevant to us, and the management then only has to pay for the task once. We will then test the work to ensure that it has been done satisfactorily, and in particular, we will test to see that unusual and exceptional items have been adequately treated. Then we will test to see that the work of internal audit has been brought to the attention of management and has been addressed adequately.

Now they are all reasonably standard things that we have talked about before,

but not yet are they in place in sufficient strength to allow us to rely on the work of all internal audit areas.

The last thing I wanted to address is: what indeed are we doing as an agency about our own internal audit? In some senses we have been very impressed with the work of the PAC. It has caused us to review quite significantly the work of *our* internal audit. For example, we had an internal audit function that was part-time and wasn't aligned with areas of the audit office that would enable it to have some substance and strength. To put it in more intelligible language, the greatest risk that I suffer in the audit office is that clean audit opinions will be given. Not that qualified opinions will be granted, because we have a system that examines that in some detail, but we don't have a system that examines the 90% of audit opinions that go out on a regular basis except for our quality review area. It seems to me that our quality review area is addressing the biggest risk that we face.

We have an internal audit over here of our, in some senses, efficiency or of our effectiveness, and we have an internal audit unit over here looking at our systems and our financial compliance. It seems to me to make great sense to bring those together in order to give it some economy of scale, and in order to give it some additional clout.

An issue we have also put on the table which has been raised by the PAC is whether we should invite external internal auditors into our shop. That's the subject of some discussion still with our executive committee with a view on one hand, if we have the external auditor involved fully in our internal audit committee, then we won't need to have external presence. But even we are not shy about the thought of hiring in

external assistance to provide some support that allows the trees to be seen as a forest instead of individual problems.

Very early on I wrote to the Chairman and the members of the PAC indicating that Report No. 71 on *Internal Audit* was a seminal document, seminal in the sense that having planted the seed, we ought to see the fruit in a year or so's time. I think from Treasury's response today we have seen the seed starting to form. What we will also need to see is that in agencies other than Treasury, and perhaps other than ours, the seed is also starting to form. We are starting to see an internal audit unit and internal audit presence in agencies that is amongst the best in Australia. Thank you for your attention.

## ESTABLISHING “BEST PRACTICES” FOR AUDIT COMMITTEES

James Guthrie, Senior Lecturer, Department of Accounting, University of New South Wales

To strengthen accountability and independence of the internal and external audit we need to have in place a functioning audit committee of some type. The paper you will receive is actually titled *Establishing Best Practices for New South Wales Audit Committees*, and I should actually thank Bill Middleton for providing research funds to undertake this piece of work. The questionnaire we sent out was late last year. The chief executive officers of 212 New South Wales public sector organisations received the questionnaire, and we had a response rate of about 51%, which we thought was reasonably well upon which to base our judgments.

The main finding was that size was an important variable to play in terms of audit committee. This is not surprising because the research into audit committees in the private sector also finds that size is important. We defined size in three ways—gross expenditure, gross revenue and staffing levels—and we find some differences in the results.

The second finding was that something like 46% of the organisations that answered the survey in the New South Wales public sector had an audit committee compared to 54% that did not. Once again, these figures are not that different from reports or surveys of practices of audit committees in the private sector, mainly of the listed companies. I am thinking of the Arthur Andersen survey there in particular.

This morning Andrew Tink pointed out that the PAC report is placing a great

emphasis on the importance of annual reports in the accountability of these organisations. If we look to the private sector we find that the Australian Stock Exchange in its listing requirements, rather than go for the mandatory option of audit committees in the private sector, has actually said that at least if you have an audit committee you should report it in your annual report.

It seems to me from the discussions we have heard today that the annual reports will be used to portray some information about the internal audit function, and maybe could be used to portray information about the audit committee function, a pleasing result from my point of view. I noticed in the *Financial Review* last week, Western Mining Corporation announced at their shareholders' meeting that they were actually going to publish the charter of their audit committee in their annual report, which is a step in the right direction.

Also I think it was interesting from Auditor-General Tony Harris' discussion, and Bob Scullion, Treasury, there might be a role for the external auditor to review internal audit, and the audit committee may be used as a vehicle for looking at this review and discussing those activities.

Another important issue we dealt with was the question of membership, and here, part of the debate about membership of course, is how we are going to construct these organisations called audit committees and who are

going to be the members. It seems to me that if we are going to try to increase the independence and try to structure these organisations to set into the government structure, we need to think very much about some of the important issues such as who is going to sit on them. Well into our survey we found there is roughly 28% of the non-executive directors or outside people who sat on the audit committee. There was a range of other people who made up the audit committee. Our findings go into the number of people on audit committees—the average audit committee had something between 3 and 5 members and met every three months.

I think the important thing here is we start to find, once we look at this, some differences now between how audit committees are structured in New South Wales—remember this is a survey of practices. Also, how do audit committees operate, and what would people like to see in the audit committees as a result of the PAC report and the Treasury response? We are finding the compositions of audit committees are significantly different in the public sector from the private sector.

Another important finding that we start to develop this idea was that in our survey we gave 15 options plus another option where we asked people to rank actually what happened in the audit committee concerning the functions of that committee. The five functions most often assigned were that the audit committee dealt with really internal audit matters. It specifically looked at financial statement audit reports if there were issues that needed to be dealt with, but the overall results of the survey was that audit committees in the public sector are about internal audit. Now we might say, "OK, that is the way they've been." But as we heard Tony Harris talk about

before, he said, "Well, if you are going to put forward the idea of an audit committee, there are three things we have to do." The second one was, as far as he was concerned, that the Auditor-General—the external auditor—should be involved in the audit committee and the scope of that audit committee.

Well, what we found was that the least five functions within these audit committees, remember we are talking about the scope of the audit committee, actually was the external audit program. The other ones were monitoring of EEO, and review of corporate codes of conduct, which is quite interesting now that we've heard the speakers this morning talking about why there's scope for internal audit now to include such things as fraud, codes of conduct and other things. We found in our survey that the audit committees—in late 1992 when people filled out the survey—were not following this wider scope we are talking about. More importantly, and Tony pointed out this as his third main one, he believed that the internal audit function and the audit committee function should be one that looks at performance of both operation and financial management. These sorts of activities were not being looked at by audit committees.

This gets to a bit of a summary. Of course, our paper that we presented, of which you will get a copy after the proceedings today, has a lot more detail in it. It seems to me that the mandatory debate, at least in the public sector, has been solved in that most people in the policy arena say that we need to have mandatory audit committees. Now the question becomes what size should those organisations be that have mandatory audit committees? I have no problem with that, and the Treasury response



picks up on that, but we need to solve how they are going to measure size.

What is interesting, I think, is that in the private sector and in the public sector, there are still a significant amount of organisations that don't have any audit committee. Also, in the private sector the mandatory issue seems to have gone soft, in that now the Australian Stock Exchange is just saying, "Well, rather than require mandatory audit committees, all we want you to do is report in your annual report that you have one," which seems to me to be moving away from that notion of establishing independence and improving corporate governance.

Well, the main issues I think, which the Public Accounts Committee recommendations hit on, is that we need to think about the size issue; secondly we need to spend a lot of time thinking about the composition of these audit committees—who should sit on the audit committees? If we are going to strengthen the independence of these audit committees, I would make an argument that we need to have external people—some sort of non-executive director. I know it's a lot harder in our departments to talk about non-executive directors, but we may be able to get some sort of non-executive representatives in there.

Finally, I believe, that the annual report, especially in the public sector, is an important vehicle for disclosing this information. We heard this morning a discussion about how even internal audit may be used in the parliamentary oversight process. It seems to me that the annual report clearly is an important document from departments and other organisations in the New South Wales public sector. There should be within that annual report specific detail concerning internal audit and audit

committees, and when we look at audit committees we should actually have their charter put in there and a number of other things. Thank you.

## PANEL DISCUSSION

**Ms Azarias:** Well, it's time for our panel discussion now, and I would like to invite our three panel members to come up on to the platform and take their seats—Mr Scullion, Mr Tink, Mr Harris.

I would like to now invite questions from the audience. I am sure all of us are intimately involved in one way or another in internal audit. The speeches of this morning have been very thought provoking and very stimulating, and I am sure that there are a number of questions out there that you would like to put to our panel.

**Q. Jim Watt from Treasury Corporation :** I have a couple of questions. The first one is pretty simple. Bob Scullion from Treasury mentioned the timetable for legislative changes arising from the Committee's recommendations—did you say that this was planned for the Autumn session of Parliament? Also, you talked about a number of guidelines that were coming out from Treasury—can you indicate the timetable for these guidelines to be published?

**A. Mr Scullion:** Yes, we hope to get the legislative change through in the Autumn session if we get through the normal Parliamentary process, Jim. The guidelines are going to take longer. There will be a fair degree of consultation with that. The guidelines are not dependent on the legislative change. We are looking at making major changes—making things mandatory. If there are minor matters we will set those aside if they affect the guidelines.

**Q. Mr Watt:** The second one is more a philosophical issue. I am not sure which

of the panel members or indeed if members of the audience might like to address it. It comes in a bit with some of the material that James is talking about right at the end with the audit committees. I think it is generally accepted that audit committees do include non-executive directors. That's certainly the case in the Treasury Corporation, completely separate from the management. The internal auditor having the direct access to the audit committee is, I think, fairly generally accepted as well. The internal audit being part of the management team or assisting management is, I think, self-evident, but why don't all other areas of the management team—the working groups in say in the engineering area or general administrative area—have access to the audit committee of the board? The audit committee is generally looking at the governance of the organisation, and in a sense I am saying, "what's so special about internal audit that it has this privileged position of reporting to the audit committee of the board, bypassing in a sense the internal hierarchy of the organisation as Tony Harris has referred to, and with the executive of the organisation?"

**A. Mr Tink:** We looked at it from a particular internal audit focus. That was the area we were looking at, I guess, and therefore we were focusing on that rather than the other groups you have mentioned. One thing that does occur to me that maybe separates internal audit from other parts of the organisation as far as the board audit committee is concerned, is that it is not part of management, and then the other, either it is or it isn't, it's not carrying out a sort of line management function. It's carrying out a checking function, and in

that sense it has a different role from all the other groups you have just mentioned. There is perhaps no reason why, depending on the nature and scope of the audit function of the board committee, those other groups may quite appropriately have some line of communication to that board committee, but we were looking with an internal audit focus.

We did see internal audit as having a different function from all the other groups, and in that sense having a line to the board committee, the distinction being that the internal audit group is not in line management, and that's the way we saw it. The other point is that, historically, particularly in some of the private sector corporate problems over the last few years, there have been some very, very bad examples of the CEO being the problem with respect to internal audit. I think it was Tony Harris who mentioned one case where the internal auditors were in fact kept away by a sort of quiet, feral personal direction of the CEO to the internal auditor from what, in fact, was the worse problem. That was I think, in one case, a billion dollar problem. Now it just seemed, arising from that, the view we took for better or worse was that there has to be a way for internal audit to get around the CEO of that type, where there is a problem of that magnitude. That's our focus, I guess, on internal audit, our focus on internal audit viz-a-viz the board. That's how we came to have that focus on the importance on that line of communication and I guess more broadly speaking, we see internal audit as having a function which is quite different from any other group that might be reporting out of an organisation to the board, that it's not a line management function. That's our thinking on it, anyway.

**A. Mr Harris:** I suppose the other issue is that the audit committee of the board specifically advises the board about the financial statements and recommends that they be signed, given that the board's ultimate responsibility is to sign the financial statements. They look to the internal audit, who are involved in accepting the adequacy of systems that support them to give them some comfort. The board is not involved, I don't believe, in any other major issue where they actually sign their names on an annual basis and be prepared to be sued on that basis.

**Q. Mrs Thuy Mellor, Chief**

**Accountant, NSW Treasury:** I think, if I can, follow from Jim Watts' question. If I can look at the issues on the point of view of the internal auditor, the benefits of the internal audit function cannot be achieved. As an ex-internal auditor, it's pretty hard to stand there and argue with a director of finance or whoever that might be that something is wrong, if you see that your future prospect depends on not upsetting a particular person. I am talking about the status of the internal auditor and their future career prospect. Internal audit can only attract the best and the brightest if that is seen as a stepping stone to something else, and I think that might be true to say that there may not be a sort of a culture in the organisation to nurture and to encourage a critical view of looking at things. So from the point of view of an internal auditor, I wonder whether the Committee or the audience have any advice on how to overcome the problem of the internal auditor being able to contribute to the process.

**A. Mr Tink:** That's a problem for everyone. It's a problem for internal audit and a problem for everybody else. I mean, I find it a problem every day of the week in here. I think the first step is

to be honest about it, and you know the PAC finds it a problem, the Auditor-General finds it a problem, everybody does. There is no easy answer to it and sometimes, depending on how it is tackled, it can make things worse or better. I sort of said all over the place, there is no rule book—it would be as thick as a telephone directory—but at the end of the day there are going to be a whole lot of judgments that have to be made. There is just no easy answer to that. I guess all that is obvious is that if this report gets adopted, and the way that it seems to be going it will, it is going to place a lot more pressure on internal audit. We see part of the way in which their greater responsibilities can best be carried out—it's coming from getting more support from the chief executive officer. The way we think the internal auditor can get more response from the chief executive officer is by making the chief executive officer responsible.

What that means is then there is a premium on internal auditors getting the training, getting staffing levels and so forth that are required to do the job, and getting on the job training, as well, in relation to the sort of extra responsibilities and difficulties they are going to encounter in taking people on within the organisation. An internal auditor can't take on a director of finance or can't deal with that sort of problem unless they know they are getting strong support from the CEO. That's why we keep coming back there. We say as a starting point in internal audit it has to take on the director of finance, therefore the first step is the internal auditor not to be reporting to the director of finance. None of it is easy, but at the end of the day, I keep coming back to this point that however hard it might be it's a heck of a lot easier dealing with it internally, even though it is hard, than it is with somehow blowing

up in a form that gets it on the Alan Jones show, where you are then coming at it back to front. It might be tough within the organisation but you think of the alternatives and it's worth making the effort.

**Q. Bob Adby from the MSB:** Just on the point that Andrew just raised, I think where the internal auditor is actually reporting within a structure mainly, say, in a finance area, it's appropriate that the structure of internal audit be that the person heading up internal audit is seen to be of at least equal stature and equal competence and have the appropriate sort of background where they can comment on the areas that they are looking at. If internal audit is going to move into those management review-type functions, which I think it possibly should have been doing for the last 20 odd years, and there were movements in Canada and the Commonwealth at a stage in that direction, then I think internal audit has to become a multi-skilled group. If it is an appropriately multi-skilled group and seen as a multi-skilled group, the attitude within the organisation towards its capabilities changes.

The other thing I would just like to comment on, which is changing the tack of the discussion a bit, earlier on there was a discussion about decentralised structures such as health. In the MSB we have very much a decentralised structure where separate ports in New South Wales have their own externally appointed subsidiary authority boards. We have found difficulties with internal audit being perceived as not being another form of external audit to those subsidiary groups from the head office area, and at the moment we are looking at restructuring internal audit into a phase of a greater degree of audit responsibility given to the managing directors within each of the groups, and

an overall internal audit committee at the main board level which the chief executive will also have access to. I am concerned that the legislation may preclude that type of functioning, but I don't really believe in a decentralised structure—internal audit is going to be seen as a positive contribution to the organisation until such time as it is allowed to contribute on the subsidiary level and report to the managing director at that subsidiary level, and I think in decentralised organisations that's an area that we are currently struggling with.

**Q. Mr Barker, Director of Finance, Department of Health:** [First minute inaudible] . . . which looks separately after the financial operations use, which is different from the slides that James Guthrie has shown. Also we have a requirement that directors of audit have to report directly to their CEOs and be encouraged wherever possible, that the external auditor be on the audit committee. What we have also found, which is a bit of a problem about not having executives on audit committees, is that sometimes we've had one case where the CEO and the chairman of the board actually worked out what went to the board, and that was often different from what went to the department, so what the department now does is we go back in a retrospect situation and ask for copies of what has actually gone to the board in terms of board minutes, finance committee reports, audit committee reports, and then we review that as to what has been coming to the department.

We also have a process where we ask all our chief executive officers each year to report on the quality of their internal audit and also their external audit because their external audits are contracted through the Auditor-General's Office, and there have been some problems there. We have also had

external auditors who haven't picked up major problems in compliance areas which amount to millions of dollars. So we have to be careful no matter where you sit, that all the checks and balances are in place, as it can lead to problems when, as Mr Tink said, you come to the 30th of June and you sign off the accounts. If they haven't been detected you then find, in retrospect, those accounts even weren't right, so it is a very complex area. We have taken a strong approach on audit committees, direct line responsibility of internal audits, and reviewing what everyone is doing. Who knows whether you are going to get it all right? You could be standing here today and tomorrow something comes up which is a major disaster.

**Q. Norm Watson, Office of Energy:** I would like to get the panel's comments, probably from Tony Harris and Andrew Tink, in terms of what I have in mind on what I see is a kind of change in balance here in the role of the internal auditor. My view of an internal auditor in the past has been where the main function of it has been to ensure the CEO, and I guess, the management of the place, and the board in turn if there is a board, that the place is functioning well and they don't get surprises, and if there are things that have gone wrong along the way, that they can be attended to. What I hear now with the notion that there is going to be a reporting by the internal auditor to the board, to the external auditor and this sort of thing, is the notion that what the internal auditor is doing and finding and saying has a primary function in going almost to someone external, to the management of the place.

I am not uncomfortable with that but I can see a situation developing where the next thing I would want to do is to think



about having another internal auditor who makes sure that the internal auditor you are talking about doesn't find these problems. I don't know whether that makes sense to you but it is really something fundamental to this question of balance and to what, in fact, we are trying to achieve, whether the CEO and the management is looking to make things effective from his responsibility or to try to pass that on to some other level of comment and review and I guess, ultimately, right outside the organisation.

**A. Mr Tink:** That's a key issue. I think on the Committee we have the view that the internal auditor should be primarily dealing with the CEO. The CEO has to run the operation day to day, and there is a real danger that if the internal auditor is spending too much time with the board, the CEO's position becomes untenable. It just seems to me to be important that the CEO is seen to be the head of the operation and in practical terms, remain so. We really saw the board as providing some input into planning of audits on a reasonably broad basis rather than getting involved, and also seeing the audit committee of the board as a safety valve if in fact something is going very wrong with the CEO.

There was one example in Victoria in the corporate world, recently, where the CEO was directing the internal auditor away from a million dollar problem. Now in that situation we see this as being crucial that the internal auditor can go to the board or the audit committee and say that we have a massive problem here and I am not getting anywhere with the CEO, but not end up running to the CEO on a daily basis. It's difficult to get the balance in there. That's the way we see it—it's not a daily thing, it shouldn't be threatening to the CEO, particularly if the CEO is working well. It should be a

rare thing, not a common one, but the very fact that it is there to be done and it is known that it is there to be done, would probably be in itself, an important mechanism for ensuring that the relationship between the CEO and the internal auditor is right.

The other side of all this is—I think it is more relevant in the private sector than the public sector—that people who are on boards have to, perhaps to an extent not previously envisaged, get involved in these things. Almost back-tracking with what I was just saying, but it seems to me now that if directors of public companies want to get insurance, their insurance companies are going to be demanding that they keep an eye on things perhaps in a way they haven't in the past. In the internal audit seminar we held this time last year we specifically had Sir Harold Knight, former Governor of the Reserve Bank, who had been on boards all over the place, address the question, *How deep should directors delve?* I think it's a pretty interesting question. I don't quite know what the answer is. He said at the end of the day it was a matter of common sense and experience of the individual directors.

One thing I am fascinated about at the moment, if you follow the literature and the commercial press, there seems to be a very strong emphasis at the moment on the selection of boards—actually the selection of the individuals going on boards. It seems to be the all important question: Who are the individuals going on boards?

The mere fact that you have a knighthood or a string of board experiences in the past—and I am not having a go at Sir Harold Knight, I have sat with him on a board and I can assure you he is extremely effective in the most constructive sense—experience has

shown that it means nothing, absolutely nothing. In fact it could be downright dangerous because it can lull people into a false sense that, "Well, they have a CV that reads like an encyclopaedia, therefore everything is alright."

Choosing an individual who has just that right balance of the sense of proportion about what is the proper place for a CEO and a common sense based on experience to sort of smell the problem and as appropriate go for it and have a look, it's, I suppose, a perennial, difficult issue. We don't see the internal auditor going to the board every day, only where there is a real problem, and I don't think a CEO working properly should be worried about it.

**Q: Michael Ockwell, Dept of Conservation and Land Management:** From the Committee's studies, was there a discernible trend as far as the effectiveness of internal audit goes when, on the one hand, internal audit is provided from within the organisation by staff, or is contracted in?

**A. Mr Tink:** We didn't get any real sense of the comparison, in defence of the Health Department and Police. We had a look in some depth at those two and I suppose for that reason we have been a little bit critical about certain things, but that is because we chose to have a look in detail. Nevertheless they do both make very strong attempts to conduct very effective internal audits, especially in the more traditional areas. My beef, I suppose, that when you go to a more broad brush mandate there is room for a fair bit of improvement. It so happens we concentrated on them. But we didn't get any sense of which was better—contracted-in or internal. I suspect that it depends on the organisation. There would be some organisations where you would expect there would be a very significant internal

audit group as a matter of course like, for example, the SRA and the Health Department, where you would expect that there would be a significant group of people inside working full time because of the nature of the organisation.

On the other hand, even with large public sector organisations with a significant internal audit group full time on the payroll, there may well be occasions when you would want to go outside for an opinion. We've heard from the Roads and Traffic Authority, which got some external opinions in relation to DRIVES—the computer project—at one stage. Part of the job of the internal auditor, even somebody heading up a large unit, may well be simply to say, "Well, I think we have to get somebody to have a look at this—this is not something the unit will do. We need to go outside, get somebody from outside in." So I think it really depends on the nature of the job. With DRIVES, for example, they were setting up something that certainly had no precedence in Australia, and in some ways I suspect had no precedent anywhere in the world, and so that wasn't just any job for the EDP auditor at the RTA. Rightly so—they went outside.

There are other instances where it is unreasonable or unrealistic perhaps having internal auditors full time on the payroll, and you would go to the Internal Audit Bureau or to some private sector firm to do the job. We don't have a problem with that, and indeed we think it's important not to be too restrictive, perhaps where chief executive officers make decisions. They should determine whether or not they want to have a full time unit, or whether or not they want to get somebody in from outside. At the end of the day they are responsible for the internal audit unit.

**Q: Jim Kropp, Price Waterhouse:** I ask a question of Tony Harris: in a number of organisations you can find a variety of audit functions—safety audit units, environmental audit units, operational audit units, even a program evaluation unit. Are you anticipating that there will be a merger of these units into an umbrella internal audit function or are you expecting better co-ordination and co-operation between the various functions within the one organisation?

**A: Mr Harris:** You are asking me to look further ahead than I would normally wish. The Canadian Auditor-General has said that the internal audit area should get used to the idea of doing environmental audits. So, in some jurisdictions they are seen to co-join. I think, in some sense, a unit that does internal audit, whether it be on financial statements or EEO or other areas of compliance with the law, makes some sense.

**Stan Howes, Northern Rivers Electricity:** Internal audit, in many areas, has been developed up to a stage where it is probably at a reasonably satisfactory level, but with all organisations of varying sizes you get varying results. I think we have come a long way in our organisation over the years, but we probably haven't gone far enough. What way can we turn now to get some professional advice as to the development of a strategic plan or a strategic direction in terms of the internal audit facility, in other words, encompassing all those sorts of things that have been talked about here today? We are not a large organisation by any means, and organisations such as ours, in particular those smaller ones, probably need some professional help in developing these strategic plans.

**A: Mr Harris:** There are a number of organisations, private or public sector that would like to help you with that issue. It is an important issue, and there are people who are skilled in providing that kind of advice.

### **Closing remarks by Patricia Azarias**

I am sure you can get plenty of advice after the seminar.

Well thank you very much for attending the seminar. I would also like to thank our panel of speakers, Mr Tink, Mr Scullion, Mr Harris and Mr Guthrie. I think this seminar is part of the whole process of raising the profile of internal audit which was, in a sense, begun earlier this year with the publication of the PAC report, and I think we can call it a success.

We have aired a series of critical issues. We have exchanged quite a wide range of views. I think there is a palpable sense of involvement and commitment there. You probably still have plenty of things you want to say. If you do want to raise any issues, do write to the PAC or to Bob Scullion at Treasury airing any points that you wish.

## **PAPERS**

## **THE AUDIT PERSPECTIVE—AUDIT OFFICE APPROACH TO INTERNAL AUDIT**

**by A C Harris, NSW Auditor-General**

The Audit Office has for a long time been active in the campaign to improve the scope and standard of internal auditing in the public sector. There have been some significant gains made in the last ten years. The most notable perhaps were: the inclusion of a requirement for internal audit in the Public Finance and Audit Act 1983 (Section 11); the issue and revision of Treasury guidelines on internal audit; increasing participation by private firms in the internal audit function; the establishment of the Internal Audit Bureau; and finally, the seminal report on internal audit issued by the Public Accounts Committee in June 1993.

In the interim, the Audit Office in 1988 and 1989 reported to Parliament on surveys that it had undertaken of the standard of internal audit throughout the public sector. The surveys disclosed a number of inadequacies in the standard of financial and compliance work undertaken by some internal audit units. Regular audit reviews since, however, have pointed to a continuing improvement.

To a large extent the audit findings were influenced by the Office's compliance with Australian auditing standards AUS1 and AUP2. This requires close collaboration between internal and external auditors. In the mid 1980s there was some dissatisfaction in the Audit Office with the application of Section 11 of the Public Finance and Audit Act. Some internal auditors were being used largely on management review work, at a cost to work that could be of use to external auditors in forming an opinion

on the financial statements. At the same time a logical reading of the Act was that internal audit involvement in performance or efficiency reviews was both desirable and necessary.

In the attest audit function the Audit Office works closely with internal audit particularly in the development of the audit plan. Our Audit Manual stresses that staff should aim to establish constructive working relationships with internal audit units, to foster the development of internal audit, to promote co-ordinated audit coverage and avoid duplication, and to take assurance from internal audit work whenever it is cost effective to do so.

On occasions it will be clear at the outset that reliance on internal audit will not be possible for the attest audit, for example where internal audit is concentrating solely on management or operational issues and not financial issues, or where it is clear from current experience that the calibre and work of internal audit is not of a sufficient standard to enable reliance on it. It is pleasing that the latter situation is not as widespread as it was in previous years.

Where it is intended to place reliance on the work of internal audit, my staff must meet their professional obligations by:

- considering whether the internal audit work has been appropriately staffed and properly planned, supervised and reviewed;
- comparing results with those of the AO on similar areas or items;

- testing transactions or balances that internal audit have tested in significant areas (reperformance);
- satisfying themselves that exceptions or unusual items which have come to light as a result of internal audit's work have been brought to the attention of management at the appropriate level and have been properly resolved; and
- examining internal audit's reports to ensure that conclusions reached are appropriate in the circumstances and any reports prepared are consistent with the results of the work performed, and examine management's responses.

Every effort is being made to improve communications between my Office and internal audit. In particular, as part of our planning process, details surrounding the areas to be examined by external audit and the approach to be adopted are being made available to the management of organisations in order to receive their input into the planning process.

Further, it is now Office policy for an engagement letter to be issued for all audits undertaken by the Office. The engagement letter includes details of where it is planned to rely on the work of internal audit. In the event that the reliance cannot be placed on internal audit, or it is chosen not to do so because of cost effectiveness considerations, this will be stated, together with the reasons for and explanations of this decision.

In other words, every attempt is now being made to ensure that we plan our audit to take account of the work, where appropriate, which internal audit is

planning to undertake for the relevant financial year.

In view of this, there will over time be considerable improvement in the co-operation and communication between my Office and internal audit. This should lead to greater efficiency and effectiveness in both the internal and external audit functions.

There is also strong agreement with the PAC's finding that audit committees provide an ideal forum to improve the process of communication between internal and external audit.

While it is almost axiomatic that the Audit Office supports the report of the Public Accounts Committee, there is a perceived area for expansion of internal audit expertise in data processing and performance or efficiency review. Indeed, the Office is making available relevant parts of its training package to internal auditors who have expressed interest in co-operating more closely with us in these aspects of auditing.

It may be of interest to round off this short paper with a quotation from the report of the Office of the Auditor General of Western Australia on its recent review of internal audit in selected government agencies. The quotation covers a number of perceptions of CEOs, corporate executives and internal auditors, about the future direction of internal audit. There is nothing in their perceptions that would be at odds with the findings of the Public Accounts Committee or indeed with the collective view of the Audit Office.

- the trend is towards becoming more strategic and forward focused. Internal audit is expected to adopt a pro-active approach to auditing which identifies risks and potential



- problems, and provides workable recommendations that will eliminate or minimise the impact of these risks;
- the direction is for internal audit to act as change agent for better management. It is expected to assist management to focus on performance and effect the change process efficiently. Internal audit is likely to take a lead role in promoting total quality and program management to promote performance and accountability for basic controls;
- audit coverage is expanding from financial compliance to performance and EDP examinations. Financial compliance is likely to have lower priority in the work program once internal controls are in place.
- develop internal audit into a group that can provide strategic services, including self audit techniques, with internal audit performing a quality assurance role;
- undertake post implementation reviews to measure the impact of audit recommendations, and prioritise future audit activities based on its results.
- with the examinations covering a wider range of operational activities, it is anticipated that internal audit will need staff with higher levels of skills and expertise. The development of a multi skilled audit staff will remain as the principal strategy to cope with this direction;
- reclassification of internal audit positions commensurate to the responsibilities and complexity of operations;
- reorganise internal audit to provide a career path for internal auditors;
- internal audit will increasingly adopt a customer orientated focus; and
- marketing of internal audit services to improve perceptions and gain wider acceptance of the function.

## **ESTABLISHING “BEST PRACTICES” FOR NSW PUBLIC SECTOR AUDIT COMMITTEES**

**by Lynn Barkess and James Guthrie, School of Accounting,  
University of New South Wales**

In Australia, public sector support for the establishment of audit committees (ACs) has come from the NSW Auditor-General's Office (NSWAGO, 1989), the Australian National Audit Office (ANAO, 1991), the New South Wales Public Accounts Committee (NSWPAC, 1993), NSW Treasury (1993) and the Victorian Commission of Audit (1993). While the concept of an independent AC is not new, the issue continues to be of interest in the public sector, with the report of the NSWPAC (1993), recommending the mandatory establishment of ACs for large NSW government agencies<sup>1</sup>. Also this report calls for Treasury to amend its guidelines with regard to ACs "to ensure that the membership and relations of public sector audit committees with internal and external auditors are consistent with best practices in the private sector"<sup>2</sup>.

The benefits of ACs in both the public and private sectors have been widely accepted in the US and Australia, with the Australian Accounting Research Foundation (AARF) outlining the perceived benefits of ACs in AUP 31 (AARF, 1991). While guidelines relating to the formation, membership and scope of ACs, have been produced by the accounting profession and emanate largely from the "Big 6" firms, e.g., Price Waterhouse, 1990; KPMG Peat Marwick, 1990; Ernst and Young, 1991, a definitive set of private sector "best practices" has yet to be determined.

In Australian policy debates there have been varied opinions on the role, function, structure and utility of ACs<sup>3</sup>.

Mainly these debates have concentrated on ACs in the private sector. Rather than provide a review of this literature in detail, this paper reports the results of a survey of NSW public sector ACs<sup>4</sup>. This survey was undertaken with the assistance of the NSW Internal Audit Bureau and was designed to discover the extent of ACs in the NSW public sector, to identify AC practices and to investigate the following six issues:

- Membership of the public sector AC;
- Frequency of AC meetings and reports;
- Functions assigned to public sector ACs;
- Importance of AC functions;
- The mandatory issue;
- Disclosure of public sector ACs in the annual report.

A survey instrument was developed and amended after pretesting and consultation with academics at the UNSW, staff from the NSW Internal Audit Bureau, and Treasury officials. The questionnaire<sup>5</sup> was structured into three sections. Section one provides general information about the organisation including title and organisational size. Three measures were used to determine size, expenditure, revenue and staff numbers. The second section explored the issues of membership, reporting, existence and oversight. Other issues addressed include the size of the AC, who chaired the AC, the number of internal and external members, how often the committee reported and to whom, and AC disclosure in the annual report. Section three consisted of two parts, the first assessed the functions assigned to the

AC, and the second assessed the value that the respondent placed on the functions assigned to the AC. Fifteen questions relating to AC functions were included in the survey. These were developed from an examination of possible AC functions identified in previous research.

After examining the 450 agencies audited by the NSW Auditor-General, the questionnaire was mailed to 212 NSW government entities. Agencies excluded from the sample were not reporting agencies in their own right. These agencies were usually either a small function of a larger body or regulatory board. Usable responses were received from 110 of the 212 organisations surveyed (51.9%). This relatively high response rate can be attributed in part to the fact that the survey instrument was mailed directly to the CEO of each of the 212 NSW government entities surveyed<sup>6</sup>.

## **Results**

The tables of the results for the total survey are presented at the end of this paper. The following section presents several of these results in more detail.

### **Existence of ACs**

Results reported in T1.1<sup>7</sup> highlight "size" (i.e., expenditure, revenues, staff numbers) as having a significant influence on whether an organisation had an AC. Larger organisations were found to be more likely to have an AC than smaller organisations. Of the 110 respondents, 51 organisations had an AC (T2.1). On average the expenditure of these organisations was \$236.9m which was significantly higher than the average expenditure for those organisations with no AC (\$47.6m). Two other variables used to measure size were revenue and equivalent full-time staff. On average,

these were significantly higher in cases where the organisation has an AC. Average revenue for an organisations with ACs was \$201.3m, while average equivalent full-time staff are 4371. In organisations with no AC, the average revenue was \$30.8m and average equivalent full-time staff was 385. In summary, on average, NSW government entities with ACs are at least 10 times larger using our three surrogates for size (expenditure; revenue; and staff numbers).

### **Membership Issue**

Twenty nine (57%) ACs have a total membership of six or less members, while twenty two (43%) have seven or more members. The most common size for an AC is four members. Ten (10) organisations had ACs comprising four (4) members, while seven organisations had 3 members, another 7 organisations had 6 members, and a further 7 organisations had 7 members each (T2.2).

Both internal and external members were identified as members of ACs. Twenty-nine organisations (57%) have between 1 and 4 internal members, 14 ACs (27%) have between 5 and 7 internal members and 2 organisations had 8 internal members (4%) (T2.3.2). Twenty-three ACs have no NEDs, 23 ACs have between 1 and 3 NEDs, 2 ACs have 4 NEDs and 2 ACs have 5 NEDs<sup>8</sup> (T2.3.3.). External auditors made up the other major category of external members. There was 32 ACs without an external auditor as a member, the other ACs (i.e., 19) had between 1 and 3 external auditors on their AC.

### **Meeting and Reports**

On average ACs meet 3.7 times per year, with 96% taking minutes of

meetings. These committees report on average 2.8 times per year, with 65.7% of these organisations disclosing the existence of ACs in their annual reports (T2.4).

### **Disclosure in annual report**

Of the 51 organisations with an AC, thirty one disclosed the existence of the committee in the annual report (T2.5).

### **Mandatory issue**

Overall 54 respondents believe that ACs should be mandatory for public sector organisations, with 56 disagreeing (T2.6). Further analysis identified that respondents recommending mandatory ACs were employed by organisations with an average expenditure of \$400m, average revenue of \$493.5m and average staffing levels of 3753. These averages are significantly higher than the size related variables for organisations where the respondent does not recommend mandatory ACs.

### **Functions**

The functions most often assigned to ACs (T3.1) in the NSW public sector included:

- (i) Monitors the performance of the internal audit.
- (ii) Receives and reviews the internal audit report.
- (iii) Ensures that matters raised in the financial statement audit reports are satisfactorily and promptly resolved.
- (iv) Ensures that non-compliance to government regulation discovered by audit management are rectified.

- (v) Is responsible for the preparation of and updating of the internal audit charter.

Of the five items listed above, three relate to the internal audit function and indicate that ACs were largely concerned with internal audit matters.

Functions least likely to be assigned to ACs in the NSW public sector include:

- (i) Monitor policies in relation to EEO procedure.
- (ii) Reviews a corporate code of conduct.
- (iii) Agrees to or recommends the annual external audit program or schedule.
- (iv) Assesses the performance of operational management.
- (v) Assesses the performance of financial management.

The patterning of functions assigned to ACs indicates a high importance of functions relating to internal audit and a low importance to matters listed above. Several of these are considered to be important for ACs in the private sector (i.e., external audit program; performance review).

In conclusion, the NSW Treasury (1993) has accepted the NSW PAC (1993) recommendations relating to ACs (recommendations 35-36) agreeing that NSW public sector ACs should "ensure liaison between the internal auditor, the external auditor and the management of the authority"<sup>9</sup>. If public sector ACs are to comply with the recommendations set out in the NSW PAC (1993) report, existing Treasury guide-lines<sup>10</sup> relating to ACs need to be updated. What remains

now is for Treasury to amend its guidelines and to make the appropriate legislative amendments to support these recommendations. These legislative changes should address the following issues:

- what criteria should be used to define a "large" government agency? Should size be measured in terms of expenditure, revenue, staff numbers or should some other measure be used to determine size?
- how are private sector "best practices" to be determined?
- are these private sector "best practices" relevant for public sector entities?

For the legislation to be successful in providing the framework to implement these changes to public sector AC practice, consultation within and with a broader community is essential.



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- 1 NSWPAC (1993) Recommendation 35.  
2 NSWPAC (1993) Recommendation 36.  
3 For a brief introduction to the diversity in the Australian policy debate see: ASX (1992),  
HRSCCLA (1992), Firth, (1992), English, (1993) ; Anon (1993); NSWPAC (1993); Guthrie  
and Turnbull (1993).  
4 Detailed analyses of these results are reported in Barkess and Guthrie (1993) and  
Guthrie and Barkess (1993).
- 5 Copies of the survey instrument are available from the authors.  
6 However, whenever there is less than 100% response rate there is a danger that the  
findings may be biased. In this case, a detailed examination of the 49% non response  
profiles, indicate that the non-responding organisations appear to be representative of  
the sample as a whole.
- 7 T1.1 refers to Appendix A, Table 1.1.  
8 One organisation failed to respond to this question and one AC had 12 NEDs.  
9 NSWPAC (1993) Recommendation 36.  
10 These guide-lines were re-issued in 1990, see NSW Treasury (1990).

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**DETAILED SURVEY RESULTS**

**1. GENERAL INFORMATION**

**1.1 Details of Organisation size - 1991-92.**

ITEM	Audit Committee		Entire Database
	Yes	No	
Average gross expenditure	\$461.0m	\$47.6m	\$236.9m
Average gross revenue	\$404.4m	\$30.8m	\$201.3m
Average staffing levels	4371	385	2214

**2. AUDIT COMMITTEES MEMBERSHIP & REPORTING**

**2.1 Does your organisation have an audit committee?**

Response	Frequency	Percent
Yes	51	46
No	59	54
Total	110	100

**2.2 What size is the audit committee?**

Number of Members	Frequency	Percent
3	7	14
4	10	20
5	5	9
6	7	14
7	7	14
8	5	9
9	6	12
10-16	4	8
Total	51	100

*Public Accounts Committee*

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2.6 Do you consider that audit committees should be mandatory for public sector organisations?

Mandatory	Total	Audit Committee	No Audit Committee
Yes	54	43	11
No	56	8	48
Total	110	51	59

3. SCOPE OF THE AUDIT COMMITTEE

3.1 Our Audit Committee carries out the following functions: 1 (always); 6 (never).

FUNCTION	FREQUENCY						
	*	1	2	3	4	5	6
Agrees to, or recommends the annual external audit program or schedule	3	17	2	1	1	3	24
Receives and reviews external audit report	2	36	2	2	1	1	7
Ensures that matters raised in financial statement audit reports are satisfactorily and promptly resolved	2	31	7	7	1	0	3
Monitors internal control procedures	2	25	6	9	2	5	2
Reviews operational audits and follow up items	3	26	7	7	3	3	2
Ensures that material frauds and errors discovered are reported to the appropriate body	4	29	5	1	0	4	8
Ensures that non compliance to government regulation discovery by audit management are rectified	3	29	7	6	2	2	2
Assesses the performance of operational management	2	12	6	6	9	6	10
Monitors policies in relation to EEO procedures	2	4	2	6	3	5	29
Reviews a corporate code of conduct	2	11	3	8	1	4	22
Assess the performance of financial management	2	18	7	4	7	1	12
Is responsible for the preparation of and updating of the internal audit charter	2	32	5	5	2	1	4
Monitors the performance of the internal audit	3	36	8	3	0	0	1
Receives and reviews the internal audit reports	3	34	5	3	2	1	3
Follows up the implementation of internal audit recommendations	5	27	6	7	1	3	2

\* No response

*Proceedings of the Seminar on Internal Audit—Implementation of Change*

2.3 Membership of the audit committee.

2.3.1 Please indicate the number of internal members of the audit committee from the following areas.

Response	Frequency							
	0	1	2	3	4	5	6	7
Number of members	0	1	2	3	4	5	6	7
Staff from policy & program administration areas	29	7	5	5	4	0	0	1
Staff from corporate services areas	28	10	9	4	0	0	0	0
Internal audit staff	24	24	2	1	0	0	0	0
Other internal staff	27	12	6	3	0	2	1	0

2.3.2 Aggregate numbers of internal members on audit committees.

Internal Members	Frequency	Percent
0	5	9.8
1	5	9.8
2	9	17.6
3	8	15.7
4	7	13.7
5	4	7.8
6	6	11.8
7	4	7.8
8	2	3.9
No Response	1	2.0
Total	51	100

2.3.3 Please indicate the number of external members of the audit committee from the following areas.

Response	Frequency						
	0	1	2	3	4	5	12
Number of members	0	1	2	3	4	5	12
Non Executive Board Members	23	3	8	12	2	2	1
External Auditors	32	12	4	3	0	0	0
Other External Members	44	3	2	1	1	0	0

2.4 How often on average does the audit committee meet?

Meeting per year	Frequency	Percent
Quarterly or more frequently	42	82.3
Three times yearly	1	2.0
Half-yearly	7	13.7
Yearly	1	2.0
	51	100

2.5 Is the existence of the audit committee reported in the annual reports?

Reported	Frequency	Percent
Yes	31	60.8
No	20	39.2
Total	51	100



## **APPENDICES**

## TERMS OF REFERENCE

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

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

## LIST OF RECOMMENDATIONS

1. Financial and reporting requirements for area health services are totally inadequate. To rectify this, the Treasurer should list area health services, the Ambulance Service, and proposed country-based regional health services separately as statutory bodies in the replacement of Schedule 2 of the current Public Finance and Audit Act.
2. The NSW Treasury and the Auditor-General should work towards the development of national standards for public sector internal auditing by the appropriate professional bodies (The Institute of Internal Auditors—Australia, Australian Society of CPAs, Institute of Chartered Accountants Australia, and Standards Association of Australia). The standards should be general enough to cover all aspects of internal auditing, not merely auditing of financial compliance.
3. As an interim measure, the NSW Treasury should adapt the internal audit standards developed by the Commonwealth Government, based on those of The Institute of Internal Auditors, for application to New South Wales, ensuring consistency with this State's statutory requirements. The standards should be issued as Treasurer's Directions.
4. In adapting the Commonwealth internal audit standards for application to New South Wales, reference should be made to the working relationship of internal audit with the Auditor-General, the Premier's Department, the Independent Commission Against Corruption, and the Ombudsman.
5. Standards will achieve their objective of raising the quality of internal audit only if there is a strong requirement for compliance. The Treasurer should therefore make specific *statutory* provision for New South Wales government agencies to comply with these standards.
6. The Office of Financial Management of the NSW Treasury should include in its annual report a section on what it has done to ensure compliance with the internal audit standards, and an evaluation of that compliance.
7. Universities should not be exempt from New South Wales Treasurer's Directions while they are administered by this State. If full Commonwealth control over universities is not effected by the time the Public Finance and Audit Act is replaced, the Treasurer should remove the statutory general restriction on the Treasurer issuing a Treasurer's Direction to a university.
8. The NSW Treasury has a substantial task to improve the framework for internal audit in this State's public sector. To assist in this task, particularly in the development and ongoing review of internal audit standards and guidelines, the NSW Treasury should establish an advisory group comprising representatives of the professional accounting and auditing bodies, the Standards Association, the Auditor-General, and some large government agencies.
9. With clear internal audit standards available, the content and role of the NSW Treasury's internal audit guidelines will need revision. The NSW Treasury should issue a new booklet on guidelines for internal control and audit, focussing on a chief executive officer's responsibilities in this area. The booklet should be maintained in an up-to-date and thorough way with regard to all internal audit requirements, and should be made readily available to agencies in both paper and electronic format.
10. Following the statutory external audit of agencies, the Auditor-General should report to Parliament on the adequacy or otherwise of NSW Treasury standards and guidelines for internal audit, and the actual performance of internal audit in the New South Wales public sector.
11. Fraud and corruption prevention strategies and systems should be made a

- top priority for review by internal audit, and the Treasurer should therefore make specific legislative provision accordingly.
12. Section 11(3) of the Public Finance and Audit Act requires government agencies to prepare accounting manuals, but this requirement is too narrow. The Treasurer should amend the legislation to *expand* the requirement for an accounting manual to include manuals covering accounting policy and procedures, internal control procedures (both financial and non-financial), and internal audit.
13. The NSW Treasury should develop, in conjunction with professional bodies, guidelines for chief executive officers and agency management generally on items to be included in the manuals referred to in Recommendation 12.
14. Chief executive officers of agencies must set in place appropriate internal controls covering *all* parts and operations of their agencies, and any doubt about this should be removed by the Treasurer with appropriate amending legislation.
15. The performance agreements of chief executive officers should include effective internal control as a key accountability, with appropriate performance indicators and performance targets, and the Premier's Department should take all necessary steps to ensure that this is done.
16. The statutory requirement for a chief executive officer to establish an internal audit function *wherever practicable* must be strengthened. The requirement to establish an internal audit function should be *mandatory*, subject to specific and limited exemptions. The Treasurer should amend the legislation accordingly, including provision for a new schedule of exemptions.
17. There will therefore need to be criteria against which applications for exemption from internal audit can be assessed. The NSW Treasury should develop such criteria, and these should address the ability of the chief executive officer to ensure that proper systems of internal control are maintained over all operations of the authority without the need for a separate internal audit function.
18. The NSW Treasury should maintain the new schedule of exemptions by assessing applications by agencies for inclusion on the schedule against the exemption criteria. Where an agency satisfies the criteria, final approval for inclusion in the schedule should rest with the Treasurer.
19. In his annual external audit of government agencies, the Auditor-General should review those agencies on the schedule of exemptions with regard to the appropriateness of their continued listing on the schedule. Recommendations for removing agencies from the list should be made to the Treasurer. The NSW Treasury should assess such recommendations against the exemption criteria. Where an agency is determined to no longer satisfy the criteria, final approval for removing an agency from the schedule should rest with the Treasurer.
20. There are many advantages of contracting-in internal audit services, but internal audit contractors need to be properly engaged and managed as for any other type of contractors. The NSW Treasury should amend the guidelines on internal audit to advise that chief executive officers who contract-in internal audit services should use the Office of Public Management's *Guidelines for the Engagement and Use of Consultants* for the selection and management of those services.
21. There is merit in using wholly outsourced internal audit, wholly in-house internal audit, and mixtures, according to the nature of an agency's operations and the need to obtain an economical, efficient and effective service. In its 1985 report on performance review practices in the New South Wales public sector, the Public Accounts Committee made a recommendation that has not yet been implemented. That recommendation is

reiterated in the current report: the Treasurer should amend the legislation to clarify that the chief executive officer is responsible for ensuring the performance of the functions outlined in s. 11(2) of the Public Finance and Audit Act, but that the organisational form of the internal audit function—that is, whether it is conducted in-house and/or contracted out—should be left to the discretion of management.

22. The NSW Treasury should ensure that the internal audit standards to be prepared in accordance with Recommendation 3 require the internal audit charter to include a positive statement on internal audit capabilities, indicating that all accountability issues are addressed. Where services are contracted-in, the capability statement should indicate how co-ordination of total internal audit coverage is achieved.
23. The internal audit standards to be developed by the NSW Treasury should include reference to the broad scope of internal audit that is appropriate to the public sector, including:
- information technology audits,
  - efficiency and effectiveness audits,
  - compliance audits, and
  - control and prevention of fraud and corruption.
- The need for internal audit to be involved with new information technology developments from early stages should be particularly emphasised.
24. Internal audit should be given a free rein to examine any area that, in the professional opinion of the audit manager, warrants attention. Any evidence that comes to light on management limiting the scope of internal audit appropriate for that agency should be regarded as evidence of non-compliance with the legal requirement for a chief executive officer to establish an effective system of internal control.
25. Internal auditors need to continue their professional education and training on-the-job, and resources have to be made available to enable this. The NSW Treasury should amend its guidelines on

internal audit to require a chief executive officer who decides to have an in-house internal audit unit to provide an explicit budget for ongoing training and education of audit staff, in line with professional requirements for internal audit. Total responsibility for the administration of that budget should be given to the manager of internal audit, and the budget should be varied only with the approval of the chief executive officer.

26. Internal audit independence from the operations of an agency is paramount. Conflicts of interest can arise, however, in some cases in which operational staff are seconded to internal audit. The NSW Treasury should include in the internal audit guidelines a requirement for chief executive officers to not use seconded staff in internal audit to audit the areas in the agency from where they are seconded.
27. Questionnaires can be useful to a chief executive officer in monitoring and improving internal audit performance. The NSW Treasury should include in the guidelines on internal audit a recommendation that the chief executive officer or the audit committee should review the quality of internal audit through questionnaires to management.
28. The Auditor-General currently seconds senior staff to agencies, at their request, to assist with establishing an effective internal audit function. With the recent establishment of the Internal Audit Bureau as a statutory authority with a role of providing internal audit services to agencies, there is a need for co-operation between the Bureau and the Auditor-General in provision of internal audit services. Before providing further staff on secondment to agencies to assist with developing the internal audit function or other internal controls, the Auditor-General should raise the matter with the Director of the Internal Audit Bureau to ascertain whether a secondment, a contracted service or other arrangement through the Bureau would be more appropriate.

29. In the public sector, in which a greater level of accountability is required than in the private sector, it is generally inappropriate for both the internal audit and the external audit of an agency to be conducted by the same auditor. The Treasurer should amend the legislation to prevent an agency from using both external and internal audit services from either the Auditor-General or a firm contracted by the Auditor-General, other than in exceptional circumstances (such as those relevant to the ICAC). The Treasurer should be responsible for approving such exemptions.
30. Many chief executive officers have failed to ensure that their internal audit units report directly to them as required by the Public Finance and Audit Act. To ensure compliance, chief executive officers should be required to specify in their agencies' annual reports diagrammatically or in the text the appropriate internal audit reporting lines, and the Treasurer should amend the legislation accordingly.
31. Chief executive officers should ensure that their agencies' annual reports include a section on internal audit covering:
- the program of internal audit planned for the year under review
  - internal audit functions contracted out and conducted in-house
  - major findings of the audit and other significant matters relating to reviews of internal controls
  - major internal audit recommendations and management's response, including reasons for not implementing recommendations
  - problems experienced in conducting the planned audit, for example, impact of unscheduled work, staff turnover
  - the audit plan for the following year
  - details of exemption from internal audit if applicable.
- The Treasurer should make the necessary legislative amendment,
- incorporating the instruction in the Premier's Memorandum 91-3 on program evaluation, as well as the current legislative requirement to report action on significant matters raised by the Auditor-General arising from the external audit.
32. Compliance with annual reporting by chief executive officers of internal audit and significant matters raised by the Auditor-General should be policed by the NSW Treasury. The Auditor-General can be used to review accuracy of information.
33. To further strengthen the independence of internal audit from the operational parts of an agency, internal audit staff should not have any ongoing line management or other operational responsibilities within the agency. The NSW Treasury should amend the guidelines accordingly.
34. The internal audit section of an agency should not be used as a pool of staff to fill temporary vacancies in the agency, and so the NSW Treasury should amend the internal audit guidelines accordingly.
35. All boards of management of large government agencies should establish audit committees of non-executive board members, and the Treasurer should provide legislation accordingly. Such audit committees should be required to comply with a revised section on audit committees in the NSW Treasury's guidelines on internal audit. The NSW Treasury should also develop criteria for determining those agencies that warrant audit committees of boards.
36. The NSW Treasury should amend its guidelines on internal audit in regard to audit committees to ensure that the membership and relationships of public sector audit committees with internal and external auditors are consistent with best practice in the private sector. In particular, the audit committee should ensure liaison between the internal auditor, the external auditor, and the management of the authority. A further function is to review implementation by



- management of recommendations made in internal audit reports.
37. Large agencies should also establish “executive audit committees”, and the internal audit guidelines should be amended by the NSW Treasury accordingly. The guidelines need to provide useful advice on the structure, functions and responsibilities of executive audit committees.
38. Ongoing parliamentary oversight of audit committees is desirable. This should be effected by the Treasurer amending the legislation to provide that, as part of the annual external audit, the Auditor-General should review the functioning of audit committees and executive audit committees, and then present his findings in the Auditor-General’s reports to Parliament. This will include review of the way the committees handle internal audit matters other than financial compliance matters.
39. Greater assistance to chief executive officers is required for them to fully appreciate the internal audit planning process and use it to allocate resources for internal audit. The NSW Treasury should amend the internal audit guidelines to explain the detailed process required to prepare an effective plan for the conduct of the internal audit function, and to show how this planning process should be used by management to assist in determining the appropriate resources required for the internal audit function.
40. In the standards to be adapted in accordance with Recommendation 3, the NSW Treasury should incorporate Statement of Auditing Practice AUP10—*Planning*, suitably augmented to include the broad scope objectives of internal audit, to assist internal audit managers with the planning process.
41. Regionalisation and decentralisation of agencies, together with devolution of line management responsibility, have increased the difficulty of providing effective internal audit. The NSW Treasury should include in the internal audit guidelines advice on internal reviews of internal audit to agencies which have audit staff outposted to regional centres or subsidiary divisions or branches away from the main audit unit.
42. In developing public sector internal audit standards (see Recommendation 3), the NSW Treasury should provide for quality assurance programs, including three-yearly external reviews, in line with the internal audit standards issued by The Institute of Internal Auditors Inc.
43. To be consistent with statutory peer review arrangements for the Auditor-General’s Office, the Internal Audit Bureau should be subject to three-yearly external reviews. The Treasurer should amend the Bureau’s enabling legislation accordingly.
44. In recognition of the professional status of internal auditing, the NSW Treasury should amend the internal audit guidelines to require internal audit staff of in-house internal audit units to have evidence of or be working towards acquiring professional qualifications and related competency standards appropriate to auditing and/or the field in which the audit is being conducted.
45. The lack of competency standards for internal audit and the absence of any statutory or other criteria to register or licence internal auditors is a weakness. The NSW Treasury should develop competency standards for internal audit units in the public sector in co-operation with the Auditor-General, the Auditing Standards Board, The Institute of Internal Auditors—Australia, and relevant employee organisations.