The relationship of the ANAO with Audit Committees and Internal Audit

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This paper outlines the respective roles of the ANAO and Audit Committees and Internal Audit, and then discusses the opportunities for, and advantages of, fostering good working relationships.

**Roles of ANAO, Audit Committees and Internal Audit**

The ANAO holds an important role in the accountability framework of the Australian Public Sector (APS), dating back to 1901 when the first Audit Act was passed by the first Australian Parliament.

The ANAO aims to meet the needs and expectations of the Parliament, the Executive and Government entities, and to add value to public sector performance and accountability through the delivery of an integrated range of high quality audit products and services that are timely, cost-effective and consistent with public sector values. Most importantly, the ANAO provides the Australian community with an independent assessment of public sector operations.

Audit Committees and Internal Audit are very important components of effective governance arrangements in any entity, in both the public and private sector. In the APS, the importance of the Audit Committee is reflected in the requirements for all entities operating under the *Financial Management and Accountability Act 1997* (FMA Act) and *Commonwealth Authorities and Companies Act 1997* (CAC Act) to establish a Committee. Also, except for the smallest of entities, Audit Committees in the APS are almost always supported by an Internal Audit group. Some of these groups have been in existence for 50 or 60 years.

Audit Committees and Internal Audit have a degree of independence from entity management. Many Audit Committees now have independent members, and some have an independent chairperson. In my view, entities with a strong Audit Committee and strong Internal Audit group are generally much better placed to meet today’s challenges than those that give less attention to the audit function. In particular, a strong and independent Audit Committee and Internal Audit function can provide management, and the CEO in particular, with valuable insights into the state of the operations of an entity.

**Evolution of audit roles**

While the widespread adoption of Audit Committees is relatively new in the APS being a requirement since the implementation of the FMA and CAC Acts in 1998, the roles of the ANAO and Internal Audit have evolved over time from the days where both were principally occupied in the assessment of compliance with procedures and controls. The ANAO has a much more significant role today than when I was first associated with the Office in the early 1970’s. For example, in those days, we had one main report, which was principally an explanation of the Treasurer’s Statement (there was no Minister for Finance at that time), whereas we now publish in excess of 50 performance audit reports annually, as well as a number of better practice guides, and provide audit opinions on more than 250 entities’ financial statements. This increasing workload has required us to continually examine ways to work smarter and more efficiently.
Equally, today’s Charter for Internal Audit often encompasses reviews of an entity’s full range of business activities and extends to advising on new technologies, improved business practices and risk management. Further, Internal Audit has a higher status now than it did many years ago with present day staff generally having professional qualifications and/or audit training. In the APS, this is partly due to the efforts in the early 1980’s of the then Public Service Board to strengthen the internal audit function.

**Internal Control**

The roles of Audit Committees and Internal Audit across the APS can be expected to become even more important following the recent decision by the Government that Chief Executives of FMA Act entities must provide certification relating to the financial management of their entities from the end of 2005–06, including in terms of compliance with the FMA Act, and also the ability of the entity to live within the approved forward estimates of expenditure. This new development will have the effect of placing great emphasis on good governance, risk management and effective administration.

This is a noteworthy development in that the Government is signaling to entities subject to the FMA Act that ‘compliance matters’, in case there was ever any doubt. This is a good thing and can only assist in entities taking steps to enhance the level of understanding of the financial framework as it relates to their operations, and lead to a stronger focus on the internal control structure. It will, however, take time for agencies to systematize the requirements to allow CEOs to give the necessary certification.

The interest in the effectiveness of internal control related to the production of financial statements, and other systems and procedures designed to ensure compliance with key legislative requirements is on the increase globally.

For example, in the United States the *Sarbanes-Oxley Act 2002* (Sections 302 and 204) mandates a range of disclosures for Securities and Exchange Commission (SEC) registrants relating to the effectiveness of internal control over financial reporting, and significant changes in these internal controls including remediation actions.

Fargher and Gramling report that an analysis of filings by SEC registrants regarding internal control remediation shows that the most common types of deficiencies for which remediation actions were being taken included inadequate staffing, inadequate segregation of duties, and problems with the financial closing process, account reconciliations and application of accounting principles. Consistent with the identified deficiencies being linked to significant controls over important financial reporting areas, Fargher and Gramling also report that the areas of financial reporting most frequently reported include revenue recognition, accounting for contracts, accounting for complex financial transactions, cut-off, and taxation issues.

There are no existing European Union requirements related to risk management and internal control, but there are a variety of European country regimes that bear on the requirements in relation to accounting records. There appears to be a recognition
though that, while Sarbanes-Oxley may not be the answer, some updating of existing requirements is necessary, and should take into account the usefulness, costs and benefits of such information to investors.ii

Much closer to home, the Joint Committee of Public Accounts and Audit (JCPAA) has expressed concern at the range of shortcomings in financial managements highlighted by recent performance audit reports, and in the case of Special Accounts, is looking for agencies to provide assurances to the Department of Finance that their administration is consistent with legislative requirements.

The interesting aspect to note with these developments is that the Sarbanes-Oxley requirements relate to internal control as it bears on the production of the financial statements; the certification by FMA agency CEOs is arguably more broadly based than this, given it covers compliance with the FMA Act which includes requirements relating to CEOs keeping proper accounts and records, and preparing financial statements (Sections 48 and 49 of the FMA Act), amongst other things. The CEO certification, as proposed, is not a public statement nor subject to audit.

Some public sector agencies have been responding to this changing environment, ahead of the recent certification requirements, by taking steps to enhance the level of assurance being provided by managers in relation to their administration and by factoring these environmental developments into their risk management and business planning processes. This is to be encouraged, not only to improve public administration, but also to raise the level of control consciousness in the agency. Going forward, Audit Committees and Internal Audit can be expected to pay greater attention to these developments.

**Common ground**

The ANAO and Internal Audit share a lot of common ground in what we are trying to achieve. We both work to professional standards and codes of conduct, and aim to improve accountability and performance in the entities that we audit. Professional standards encourage co-operation between internal and external audit in the context of the audit of financial statements and to increase audit efficiency by minimising duplication. Internal and external audit both make use of the private sector, where needed, to gain specialist expertise and to supplement our own resources so that we can complete our work. We have many common operational issues and a recognition that we need to manage effectively our stakeholders, the quality and timeliness of our work, our own business practices and, very importantly, our staff.

With this background in mind, there is much to be gained from strong relationships between the ANAO and Audit Committees and Internal Audit, and the sharing of our experience. These relationships should not be limited to the interaction of people, but also include our operations and products, as appropriate.

**Audit committee liaison**

The ANAO endeavours, to the extent possible, to maintain high level representation at Audit Committee meetings, with the relevant financial statement Executive Director attending most meetings, and where applicable, performance audit staff also attending
meetings. Effective interaction between ANAO and entity executives at and beyond these meetings, can set the tone for interaction by other officers and lead to a better understanding of our respective responsibilities and ultimately better outcomes for the entities concerned and the Parliament. Also, by attending the Audit Committee meetings and occasionally meeting separately with Committee members outside of those meetings, ANAO staff gain a better insight into the business workings of the entity. The Committees also benefit from being able to discuss our audit programs and audit findings.

Audit Committees often do, and in my view should, play an important role in the monitoring of the progress of the implementation of both Internal Audit and ANAO recommendations. Where this is done, the effectiveness of Internal Audit and the ANAO is strongly enhanced because implementation of recommendations generally leads to improvements in public sector performance and accountability. The presence of ANAO and Internal Audit staff at Committee meetings is likely to strengthen this process as the staff can advise Committee members directly on the significance of the issues involved.

Audit Committees also generally have a role in advising the CEO on the clearance of financial statements. This process is very valuable to the ANAO in resolving audit issues and enabling reporting deadlines to be met. It also provides the Committee with an opportunity to better understand the financial operations of the entity and the implications of audit issues.

**Internal Audit liaison**

Some entities, particularly the larger ones, use their Internal Audit group as a liaison point for ANAO activities. This generally increases the opportunity for developing a good working relationship between the ANAO and Internal Audit, because it makes Internal Audit the first point of contact for ANAO staff.

Where there is no formal protocol for contact between the ANAO and Internal Audit, both parties must, nevertheless, make an effort to develop and maintain a close working relationship. Sometimes this may not be easy, particularly where the Internal Audit function is outsourced to an external provider and there is not a permanent presence. In such cases, the relationship between the ANAO and the Audit Committee may become all the more important, as this relationship can encourage greater interaction with Internal Audit.
Audit planning

Audit planning is an area where the ANAO and Internal Audit can benefit significantly from working closely together. The development of strategic Internal Audit work programs assists the ANAO in conducting its work, as it is possible in some instances, for our auditors, especially our financial statement auditors, to reduce ANAO coverage due to reliance on the work of Internal Audit. The timing of such work is therefore paramount.

By the same token, we would expect Internal Audit to be able to use many of our audit reports, especially some of those undertaken across entities, such as our business support process audits, and our better practice guides, to provide valuable information and areas potentially requiring Internal Audit coverage. I would encourage Internal Audit to keep abreast of these products and advise the Audit Committee accordingly. I know that some entities require management to assess themselves against some of our cross-entity reports and better practice guides so that, if and when, Internal Audit or the ANAO decide to do an audit, the entity is likely to be well placed to get a positive result (conclusion).

Specific areas which stand out as beneficial for internal audit coverage, on the basis of ANAO work, includes areas of legislative or regulatory risk (referred to earlier), the effectiveness of controls in major business systems, reconciliations, and any major work arounds.

There should be regular liaison between ANAO and Internal Audit in developing the audit programs so as to avoid duplication in coverage and to coordinate timeframes and access for audit teams. This is particularly so, given the need to make the best use of available resources. The identification of risks and the maintenance of records of previous audit coverage and results are important elements in developing the audit programs. Legal compliance issues should also be given attention. Both parties should be willing to exchange this information and to adjust their programs in the best interests of efficiency and effectiveness.

Internal Audit and the ANAO may also develop audit programs jointly. In the case of one of our more significant financial statement clients, a coordinated annual plan outlining audit coverage for each of the entity’s key risk areas is presented to the Audit Committee in June of each year. This plan is signed-off by the relevant ANAO Executive Director and the Head of Internal Audit. The coordinated plan indicates which work is to be done by each party and any work that the ANAO plans to place reliance upon. The plan makes it clear that each party’s individual responsibilities remain unchanged and is supplemented by the respective plans of Internal Audit and the ANAO. I believe there is scope for extending this coordinated planning approach to other clients and also for including ANAO performance audit coverage, where applicable.
Our annual program of performance audits is published in July each year and is available on our website. The program covers both entity-specific and cross-entity audits, including the business support process audits done by a branch within our financial statement audit group. Our draft program is issued to entities beforehand and ANAO staff are able to discuss the proposed program, prior to it being finalised. Internal Audit staff should desirably make themselves aware of our program and contact relevant ANAO staff, as necessary.

The Internal Audit work program should be kept up to date and made available across the entity and to ANAO staff as it changes. The better intelligence held by both parties, the better the resulting audit programs should be. Also, by using the appropriate expertise of ANAO or Internal Audit staff, both parties are able to produce higher quality, and better-targeted audit products.

**Using each other’s work**

The ANAO has its own Auditing Standards, which adopt Australian Auditing and Assurance Standards, while Internal Audit is principally guided by the professional standards issued by the Institute of Internal Auditors. As a result of this high degree of professionalism, there are occasions where we may confidently make use of each other’s work.

As indicated earlier, in some instances, the ANAO may rely on Internal Audit work to reduce its audit coverage. This is typically done in financial statement audits, but may also be done in performance audits. There is an Australian Auditing Standard on *Considering the Work of Internal Auditing*, which sets out all the requirements that need to be met when using Internal Audit work.

Even where reliance is not placed on Internal Audit work, its reports can provide valuable information for ANAO staff reviewing financial statements or other activities of the entity. This is because the Internal Audit topic may be of part interest or provide useful background or contextual information (particularly where a relevant audit has been completed in an earlier period than that of the ANAO review).

As well as using Internal Audit work, ANAO staff can benefit from the business knowledge of Internal Audit staff, as they have a more extensive knowledge of the entity’s business and operations. So even where there is no relevant Internal Audit work to examine, it is always worthwhile for ANAO staff to have a discussion with their Internal Audit counterparts before embarking on an audit.

I believe there are mutual benefits for entities and the ANAO, in Internal Audit undertaking more work that may be relied upon by the ANAO. This is particularly so, in the areas of legal compliance and accounting control that may have relevance to our financial statement audits. By way of example, one of our clients assigned 90 days of internal audit effort to support the ANAO audit team in the year-end audit of the 2005-06 financial statements – the audit work primarily involved subsidiary ledger reconciliations, confirmation of balances and analytical procedures.
Of course, while possibly not as common, there will be opportunities for Internal Audit staff to use ANAO work. This will be mainly limited to audit reports to management held by the entity and reports to Parliament, as our working papers are not generally provided to other parties. As mentioned earlier, these reports may provide valuable information for planning purposes. They could also, in certain instances, be used to complement or reinforce Internal Audit work.

Audit Reports and Better Practice Guides relating to Internal Audit

The importance of Internal Audit and Audit Committees is also reflected through a number of ANAO publications.

Our last audit report on Internal Audit was Audit Report 2004-05 Management of Internal Audit in Commonwealth Organisations, tabled on 23 July 2004. It covered two departments (Health and Ageing and Employment and Workplace Relations), one prescribed agency (IP Australia) and one CAC Act entity (Comcare). The audit concluded that the four entities had established an Internal Audit group with responsibilities and accountabilities that were largely consistent with better practice principles and professional requirements, as well as the legislative requirements for Audit Committees. The report made eight recommendations for improvement. These included aspects relating to Committee responsibilities, audit work programs, review and monitoring of recommendations, Internal Audit charters, provision of professional guidance, and performance measurement.

Our Better Practice Guide on Audit Committees was published in February 2005. From all reports this guide has been well received by entity Audit Committees and Internal Audit groups. The Guide outlines the relevant considerations in establishing and operating a better practice public sector Audit Committee and provides model charters, checklists and other material to assist with the implementation of better practice.

In addition, our audit reporting on financial statements usually comments on Audit Committees and Internal Audit. Our most recent report, Audit Report No.56, 2004-05 Interim Phase of the Audit of Financial Statements of General Government Sector Entities for the Year Ending 30 June 2005 provided four to five pages of commentary on Audit Committees and Internal Audit in a chapter on the Control Environment. The commentary noted, among other things, that Audit Committees were making good use of the Better Practice Guide, and Internal Audit groups were generally providing an effective service to the executive management by assisting them in the conduct of their governance responsibilities.

One matter of interest, arising from the financial statement audits, was that in some entities, there was no overall responsibility assigned to ensure that legal and compliance risks had been considered and/or effectively monitored. This is an area that should be considered in assessing organisation risks, these risks being broader than those related to the FMA Act.
I also encourage Internal Audit to keep abreast of broader public sector issues and developments and to engage Audit Committees in discussing these matters in the context of their respective entities. Apart from legal compliance, some of the general issues and developments arising from ANAO audits that might be discussed by Internal Audit and Audit Committees include:

- contract and project management;
- recordkeeping;
- effective governance;
- business continuity management;
- performance measurement and management; and
- risk management and setting the risk ‘appetite’.

**Conclusion**

In conclusion, there are many opportunities for the ANAO and Audit Committees and Internal Audit to establish close working relationships for the benefit of each party and most importantly, for the benefit of the Australian Public Sector as a whole. I encourage both my staff and entity staff to make the most of these opportunities and to put effective working relationships in place. The roles of Internal Audit and Audit Committees are important in today’s public sector, and will become ever more so in the years ahead, given the increasing accountabilities of CEOs for entity performance.

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1 “*Toward Improved Internal Controls*” The CPA Journal, New York, June 2005, Vol 75, Iss.6; pg 26, 4 pgs.