

THE WHOLE POINT OF AUDITING IS TO MAKE THINGS BETTER

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**Institute of Internal Auditors Australia. South Pacific and Asia,
Conference SOPAC 2001, Melbourne, 26 March 2001**

Thanks are due to Bill Bonney and Richard Rundle of my Office
for assistance in preparing this address



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1. INTRODUCTION

I am pleased to be invited to give the opening address at the Institute of Internal Auditors Australia. South Pacific and Asia, Conference SOPAC 2001. The importance of the role of Internal Audit to organisations cannot be underestimated. As we enter the year 2001 the demands on Internal Auditors have never been higher. Maintenance and enhancement of skills is critical if Internal Auditors are to continue to be a key part of the corporate governance arrangements in the future. The program for this conference meets that challenge – reinforcing the relationship between corporate governance, risk management and internal audit; as well as tackling the technicalities of internet and e-commerce security, and fraud in a sophisticated Information Technology (IT) environment. The material to be covered in these sessions is critical to the continuation of an effective internal audit operation.

Those of you who are in the public sector have all the technical audit change issues to deal with as well as the considerable public sector reform that has been occurring in Australia and elsewhere over recent years.

The past decade has seen a period of quite marked change in public sector administration in most countries. This has been brought about by both a reassessment of the role of government together with emerging trends associated with globalisation and the information age, which have the potential to transform dramatically the way governments do business.¹

As well as the similarities, it is important to recognise the basic differences between the administrative/management structures of private and public sector entities and between their respective accountability frameworks. The political environment, with its focus on checks and balances and value systems that emphasise the public interest, however that is defined, including issues of ethics and codes of conduct, indicates different demands on corporate governance frameworks to those placed on a commercially oriented private sector. It is equally important to recognise that the diversity of the public sector is also likely to result in different models of corporate governance across the Australian Public Service. That is, one size does not fit all, even though there will be common elements of any such models.²

The issues of openness and transparency have to be accepted as essential elements of public sector accountability, as indeed do public service values.³

It has been increasingly recognised in both the private and public sectors that appropriate corporate governance arrangements are a key element in corporate success. They form the basis of a robust, credible and responsive framework necessary to deliver the required accountability and 'bottom line' performance consistent with the organisation's objectives, even where that bottom line is difficult to measure.⁴

The real challenge is not simply to define the elements of effective corporate governance but to ensure that all the elements of good corporate governance are effectively integrated into a coherent corporate approach by individual organisations and are well understood and applied throughout those organisations.⁵

A sound corporate governance framework can help to provide the essential discipline and structures, as well as a level of assurance to management and staff that not only are performance requirements of stakeholders being addressed but also that effective action is

being taken to achieve expected results. Risk management is a central element of any sound corporate governance framework, whether in the private or public sectors. It requires considerable commitment and ownership, particularly investment, by senior management and generally at all levels of the organisation.⁶

Risk management is primarily the responsibility of the Chief Executive Officer (CEO) and/or board. Effective governance arrangements require directors to identify business risks, as well as potential opportunities, and ensure the establishment, by management, of appropriate processes and practices to manage all risks associated with the organisation's operations.⁷ Internal audit can be a major source of assurance in relation to the implementation of an organisation's risk management program and in ensuring the ongoing effectiveness of its practices for managing business risks. However, I stress that the latter is not the responsibility of internal audit.

A successful internal auditor is one who looks out for the CEO's (and Board's) interests. That auditor will ensure he or she understands the business and what concerns the CEO and, of course, the Audit Committee. The faithful completion of an approved program does not necessarily ensure its success. The internal auditor who makes time to 'test the pulse' of the organisation is likely to be one that makes a difference and adds value to his/her organisation. However, there is also no substitute for professionalism and experience to establish the necessary confidence and credibility in the function.

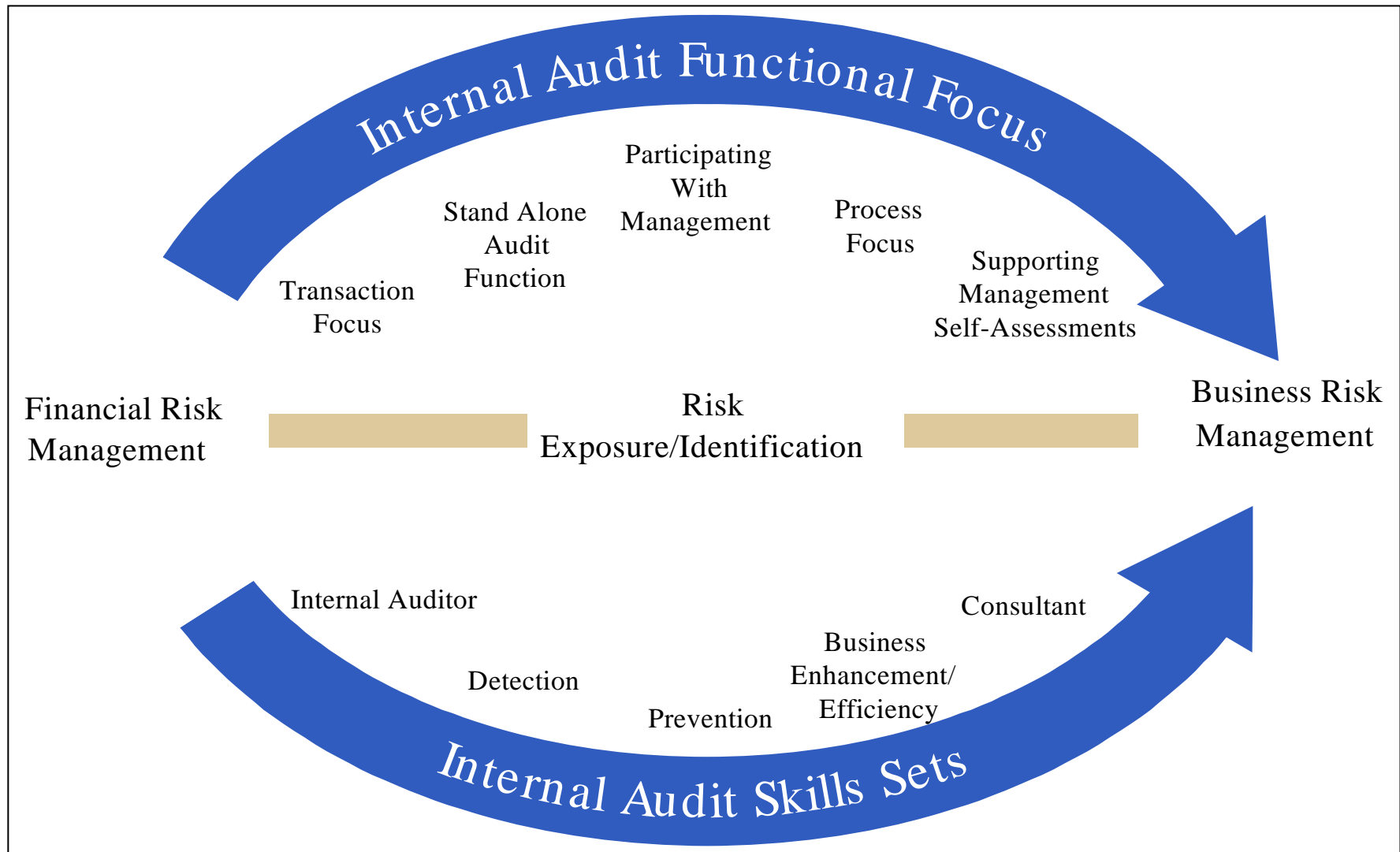
2. THE CHANGING ROLE OF INTERNAL AUDIT

The traditional role for internal audit is well documented and understood. It centres on the examination, evaluation and monitoring the adequacy and effectiveness of the control structure of an organisation. However, even within that narrow context, the contribution by internal audit is potentially of major importance by ensuring that an organisation's control structure:

- improves accountability;
- promotes ethical and professional business practices;
- advances risk management;
- enhances communications, decision making and performance reporting; and
- contributes to quality outcomes or results.

However, increasingly, the Internal Audit role is being more broadly prescribed to encompass roles such as 'business partnership', 'independent adviser' and 'consulting activity'. Best practice now views internal audit as being forward looking and having a decision support role which is linked to the processes, techniques and tools employed by an organisation to achieve its strategic objectives. I am indebted to Ross McColl, Internal Audit Services Partner of PricewaterhouseCoopers, for permission to use the following figure (page 3) which outlines the evolution of the internal audit function in organisations which have adopted a whole of business risk management strategy.

Figure: Evaluation of the Internal Audit Role in organisations with a whole of business risk management strategy



Source: McColl R 2001, *Audit Committee Matters - Internal Audit*. Special Edition, PricewaterhouseCoopers, January, p. 4

Some examples of such a broader role involve assisting with the maintenance of good corporate governance practices by promoting, and participating in, regular surveys of staff, management and clients to assess:

- leadership issues across the organisation;
- any staff morale concerns;
- perceived problems within any aspect of the organisation's operations;
- the ethical conduct and Australian Public Service (APS) values-based approach being adopted;
- the control consciousness of staff;
- the adequacy of communication;
- adequacy of control structures;
- the adequacy of reporting and monitoring;
- the quality of service provided, timeliness and problems associated with service delivery; and
- how well the organisation's goals and objectives and vision for the future are being met and that management strategies are effective.⁸

Consistent with modern auditing practices, the ANAO's financial statement audit approach is based on an analysis of business risks; the way in which an organisation explicitly manages its business structures and operations; the extent to which we can rely on business processes and controls; and the extent to which we need to test the business and accounting processes and related internal controls as part of sound corporate governance.

By virtue of its position within an organisation and its relationship with the executive of the organisation, Internal Audit is also well placed to make a significant contribution to the implementation of the many public sector reforms. To do so, internal audit staff need to have a thorough appreciation of the current reforms facing the organisation and the industry in which it operates and the consequent implications for its performance. In the APS, such reforms include the introduction of accrual budgeting; output/outcome funding; performance improvement and market testing requirements; greater use of purchaser/provider arrangements, as well as contract management; and devolved banking arrangements. While much of such activity is familiar to private sector auditors, the real test for public sector auditors is that public sector managers are not.

But there are also particular activities that are peculiar to the public sector. For example, a significant new imperative to good business and management practices in the Australian Public Sector, which internal audit ought to influence, is to ensure implementation of the policies and procedures of the Protective Security Manual - promulgated in October 2000.⁹ That manual provides:

... the benchmark for good security practice. Agencies should conduct regular security audits to ensure that protective security measures are being implemented efficiently and effectively.¹⁰

Internal auditors need to be seen as adding value to an organisation. For example, internal audit may adopt a proactive approach in providing management with highly specialised, independent advice on improving the organisation's efficiency and effectiveness and adding value in areas such as:

- revenue enhancement and cost reduction;
- improving customer relations;
- maximising the benefits of technology;
- evaluation of management control;
- improvements to achieve operational best practice;
- top quality management; and
- timely problem identification and analysis.¹¹

There is an ever increasing requirement for auditors to be part of review and/or evaluation activities in a diverse range of areas. However, there are potential conflicts of interest likely in advisory/auditing activities which need to be managed sensibly. Nevertheless, some evaluations would benefit markedly from skills and knowledge of internal audit staff. An example could be the design of, say, new information technology (IT) or other systems to ensure they meet accountability requirements and add to the confidence and assurance of organisation users. However, auditors need to maintain that peculiar characteristic of the profession which is their 'independence'.

3. AN EFFECTIVE INTERNAL AUDIT FUNCTION

Principles of Better Practice

ANAO's research has suggested a number of principles that should support a successful and effective internal audit function.¹² These are briefly discussed below.

Management support

It is generally accepted that, to be effective, the internal audit function must have the full support of the organisation's senior management. The clearest signal of support for the internal audit function is the Audit Charter. The charter should be used to formalise the framework within which internal audit operate and include information on:

- authority, responsibilities and accountabilities;
- professional standards;
- planning and reporting processes;

- quality assurance processes; and
- relationships with external auditors.

The support of line management is also critical. Opening and maintaining a constructive dialogue with its key stakeholders; aligning its audit effort with the key business risks of an organisation; and considering the design and mix of its audit products to best meet the needs of its clients; are all important responses to ensure management support.

The attitude of management towards internal audit can have a significant influence on the behaviour of an organisations staff - similarly the attitude of management towards internal audit can either strengthen or hamper its role.

Focusing on risk and meeting client needs

The planning of the internal audit section should reflect the organisation's business planning and align the audit effort with the key business objectives and the critical business risks.

Internal audit's focus should be on critical business processes and areas of high risk; be relevant; and give due weight to the needs and expectations of line managers.

An important consideration for internal audit when planning its program of coverage is the appropriate 'product' vehicle for delivery of its service. There is a continuum of client needs ranging for assurance to process improvement, which should be matched to a range of products—from the traditional audit through to 'consulting' activities.

Maintaining necessary skills and qualifications

Building up a balanced pool of resources is critical to an effective internal audit function. The competencies of internal audit staff must take into account the skills and knowledge base laid down by the profession. This includes personal qualities, standards of education, sound judgement, innovation and operational and auditing/evaluation experience.

The skill requirements for internal audit should be aligned to the nature of the organisation's business, its risk profile and the associated needs of management.

The changing role and focus of internal audit activity means there must be a broader range of competencies than required for traditional internal auditing. It needs also to address the composition of its audit teams if it is to undertake a range of activities. A particular, and growing, requirement of internal audit management, at least in the APS, is to oversight effectively outsourced internal audit activities.

Ensuring continuous improvement

Internal audit's processes should be subject to ongoing monitoring, review and evaluation. The concept of continuous improvement requires internal audit not just to measure its current performance but also to assess it against some standard or target. It demands the development of balanced indicators of performance, preferably with input from the Audit Committee and line management. Ideally these indicators should be benchmarked against other internal audit departments.

In this regard, the benchmarks (categorised as input, process and output) across cost, time, quantity and quality dimensions, which are outlined in our report *Benchmarking the Internal Audit Function*,¹³ may be useful.

The ANAO proposes to continue benchmarking selected aspects of Internal Audit in conjunction with another project on *Benchmarking the Finance Function* which is expected to be released before the end of this calendar year.

By promoting continuous improvement internal audit can also be a powerful sponsor or aid to improving processes within the organisation.

Client surveys are another effective way to obtain quantitative and qualitative feedback from clients and stakeholders. Surveys should be as concise as possible to permit completion in a reasonable time frame, a consistent evaluation scale should be used to facilitate comparability and consider points should be used to reduce subjectivity and ensure consistency of interpretation.

Internal audit's relationship with the Audit Committee¹⁴

The Audit Committee is an integral part of an effective internal audit operation. Internal audit and the Audit Committee need to develop a mutual trust and confidence and a clear understanding of each other's roles and functions.

In overseeing internal audit, the Audit Committee should ensure that the function is appropriately resourced. In doing so, they should actively participate in the selection of the head of the internal audit function and should seek assurances that the qualifications, and skills sets of internal audit staff (in-house or contractors) are commensurate with the agreed strategic direction.

Ross McColl of PricewaterhouseCoopers observed in the article, quoted earlier, that:

The greater emphasis today on corporate governance, together with the increased focus on company performance, has resulted in an increasing number of audit committees and management groups reassessing their internal audit functions. We have recently noted some consistency in the role of internal audit in organisations which have embarked on a "whole of business risk management strategy.

*In these organisations there is a consistent strategy which shows internal audit evolving to spend more time working alongside management, as well as acting as controls and assurance advisers. These organisations have adopted a strategy to actively promote management's ownership of risk as fundamental to the success of the organisation. This management strategy is recognised as being more than just carrying out a risk assessment, it is about building attitudes, priorities and evaluation systems, so that risk management becomes a usual business process.*¹⁵

As part of their annual review of internal audit, the Audit Committee would want to be assured that the quality control mechanisms established for internal audit work have been followed. In this regard, the Committee may wish to consult with the external auditor and seek our views on particular aspects of internal audit.

Some examples of the Audit Committee's specific responsibilities in relation to internal audit activities are:

- review and endorse the internal audit charter;
- take an active role in the appointment of the Chief Internal Auditor;
- make final informed recommendations on internal audit staffing requirements;
- endorse the internal audit strategic plan and annual work program and monitor progress against the plan;
- oversee the internal audit function and its liaison with the external auditor and management;
- review internal audit reports and monitor and critique management's responses to findings and the extent to which recommendations are implemented; and
- monitor the effectiveness of the internal audit function.

Outsourcing the Provision of Internal Audit Services

A current issue of particular interest in relation to Internal Audit is that of outsourcing or co-sourcing.

On one front is the issue that the necessary skill sets and knowledge requirements are varied and complex and rarely reside wholly within one individual or even a small number of people. This can be a major factor impinging on the effectiveness of internal audit sections, particularly small ones.

Outsourcing, in whole or in part (that is, co-sourcing), provides a mechanism whereby the internal audit resource base can access the skill sets and knowledge it needs at a reasonable cost, particularly in a rapidly changing environment.

The issue is perhaps less clear for those organisations which require a comparatively larger internal audit resource base and are therefore more likely to be able to attract, and retain, the necessary skills and knowledge within the organisation.

The ability of an outsourced internal audit cell to possess a knowledge of the implications of reforms and of the intricacies and complexities of the organisation must be balanced with any cost savings. An option in these cases is to consider an in-house management or, at least, an oversighting capability. As I mentioned earlier, the effective internal auditor needs to know the issues that concern the CEO. This is difficult enough for a member of the organisation, but for outsourced operations, the challenge to meet the needs of CEOs can be even greater.

The internal audit service provider should have the confidence of management to be able to identify, articulate and provide credible organisation based approaches and practices to fulfil its accountability, obligations and enhance its overall performance. To do so, it is essential for the contracted provider to have a good understanding of the organisation's business and the changing private and public sector environments. Again, it is a question

of establishing the 'right balance' to meet the corporate governance needs of the organisation.¹⁶

4. CONCLUDING REMARKS

It does concern me that the Canberra Branch of the Institute is struggling to maintain its viability as a separate branch with fewer than 100 members locally. Nevertheless, the Canberra Board is rising to meet the challenge with a more widely representative stakeholder membership as part of a ten point plan for this year to arrest the decline and re-invigorate the Branch's activities. A senior member of my Office has joined the Board and I wish them well.

What this situation reinforces with me is the need for all of us to constantly review our performance and the contribution we make. There are concerns about confidence and credibility but there is a real issue of relevance that we have to tackle. And we will do that if we all work together under the banner of a professional body such as the Institute, which may have to look at raising its own profile within both the public and private sectors. That is obviously a matter for the Institute to address. Major conferences such as SOPAC can contribute a lot in that respect and I am sure this conference will do just that.

I would like to conclude this address by passing on some practical advice from R. Richard Riggs MPA in his article "*How to think like an Auditor*" in a recent edition of the United States Government Accountants Journal, from which I took the title of this address.

Your role as an auditor is different in crucial ways from that of an accountant, a cop, a lawyer or an administrator. Maybe the occupation most analogous to the auditor is the judge, who must be impartial, devoted to finding the truth and unafraid to make tough calls about what they find.

An accomplished generalist, a professional asker of questions and a devout sceptic, an auditor must be curious, independent and aware of how each action and decision affects the rest of the project.

Auditors are snoops. They are paid to ferret out problems and not all problems are readily apparent nor are they readily volunteered by most auditees. An audit plan, no matter how well thought out, can't anticipate all the potential problems the auditor may find in the field. And no audit plan can substitute for an alert inquisitive auditor who can recognise a problem, analyse it, track it to its source and recommend practical real world solutions.¹⁷

And please remember, '*The whole point of auditing is to make things better*'.¹⁸

I wish you all a very successful conference with benefits both for the individuals attending and for the proud profession of which we are all a part.

NOTES AND REFERENCES

- ¹ Barrett Pat 2001, *Risk Management in the APS Today and Tomorrow*, Monash University, Melbourne, 21 February.
- ² *ibid.*, p. 2.
- ³ *Ibid.*, p. 2.
- ⁴ Barrett Pat 1999, *Seeking to Make a Real Difference Confronting long held Cultures and Attitudes*, presentation to the Secretaries' Forum , Canberra, 2 March.
- ⁵ *ibid.*, p. 3.
- ⁶ *ibid.*, p. 4.
- ⁷ Department of Finance and Administration 1999, *Submission to the JCPAA Inquiry into Corporate Governance and Accountability Arrangements for Commonwealth GBEs*. Submission No. 4, Canberra, 2 July.
- ⁸ Barrett Pat 1998, *Internal Audit in the APS - Surviving in the new Millennium*, presentation to the Institute of Internal Auditors Australia, SOPAC '98, Canberra, p. 8
- ⁹ Attorney-General's Department 2000, *Commonwealth Protective Security Manual 2000*, Commonwealth of Australia, Canberra, October.
- ¹⁰ *ibid.*, p. A22.
- ¹¹ Barrett Pat 1998, *Op.cit.*, p. 10.
- ¹² For more information, refer to the ANAO's Better Practice Guide titled *New Directions in Internal Auditing - A Guide for Public Sector Managers*, published in July 1998.
- ¹³ ANAO Report No. 14 2000-2001, *Benchmarking the Internal Audit Function*, ANAO, Canberra, 26 October, pp. 27-51.
- ¹⁴ For more information, refer to ANAO's Better Practice Guide titled 'Audit Committees' issued in July 1997.
- ¹⁵ McColl R 2001, *Audit Committee Matters - Internal Audit Special Edition*, PricewaterhouseCoopers, January, p. 4.
- ¹⁶ Barrett Pat 1998, *Internal Audit in the APS - Surviving in the new Millennium*, *Op.cit.*, p. 18
- ¹⁷ Riggs R. Richard 2000, *Auditing Government in Today's Environment - How to think like an Auditor*. The Government Accountants Journal, Winter 2000, pp. 11 - 12.
- ¹⁸ *ibid.*, p. 14.