

# The Institute of Internal Auditors – Australia

NATIONAL OFFICE: Level 10, 222 Pitt Street SYDNEY NSW 2000  
PO Box A2311 SYDNEY SOUTH NSW 1235  
Tel: +61 2 9267 9155 Fax: +61 2 9264 9240  
email: enquiry@iia.asn.au



ABN 80 001 797 557

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27 May 2002

Mr Adam Cunningham  
Inquiry Secretary  
Joint Committee of Public Accounts and Audit  
Parliament House  
CANBERRA ACT 2600

Dear Mr Cunningham

The Institute of Internal Auditors-Australia thanks the Joint Committee of Public Accounts and Audit (JCPAA) for the invitation to provide comment on the *Review of Independent Auditing by Registered Company Auditors*.

Our recommendations are attached.

The IIA-Australia has 2000 members across all states and territories. Our members are in a diverse range of fields from public and private sectors, education, and also public practice and consulting. The IIA-Australia is part of an international body (the Institute of Internal Auditors Inc), which has over 70,000 members in internal auditing, corporate governance, internal control, Information Technology audit, education and security. The Institute has members in more than 100 countries and is the acknowledged leader in standards, certification, education, research and technology guidance for the internal auditing profession. The Institute has a *Code of Ethics; Standards for the Professional Practice of Internal Auditing; and certification program (Certified Internal Auditor)*. In Australia, the ICAA recognises the IIA-Australia as the appropriate "Accredited Organisation" to certify CAs as specialists in internal audit.

The Institute would be pleased to participate in the public hearings commencing in June/July 2002.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Chris', with a long, sweeping underline.

Christopher McRostie  
Executive Director

## **INTRODUCTION**

The Institute of Internal Auditors – Australia (IIA – Australia) has been concerned over the past 10 years or so, that the providers of external audit services have subsumed a range of business functions within the corporate and some public sectors which we believe is inappropriate. The key example of the drift over this time is the outsourcing of a number of functions, including internal audit. This drift has on occasion compromised the independence of those providing external audit services.

It needs to be acknowledged that there are two audit functions. The two audit functions, external audit and internal audit, have distinctly different purposes, objectives and skill sets.

In recognition of the change in the nature of internal audit work, the IIA at the international level changed the definition of internal auditing in 1999 to:

*Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.*

Anyone undertaking internal audit work must be suitably qualified. In the view of the IIA-Australia, this means being a member of the IIA-Australia and, to demonstrate highly developed knowledge and expertise, to hold the designation CIA (Certified Internal Auditor).

## **BACKGROUND**

The composition and role of the Auditor Independence Supervisory Board as laid out in the Ramsay Report (*Independence of Australian Company Auditors*) is supported by the Institute. It has been noted that the composition of similar bodies overseas tended to be dominated by the professional accounting bodies and public accountants. The views of the proposed Board should not be influenced by the significant commercial interests of the "Big 4". The Institute believes that the proposed composition is appropriate to ensure a broad cross section of views. We suggest that one of the Board's first activities should be to clearly state that external auditors cannot provide any other services to their audit clients. We contend that in providing internal auditing services or other consultancy services, the independence (perceived or real) of external auditors may be compromised.

It is clear that the Board will need funding to attract highly skilled and experienced professionals to continually review, assess and report on external auditor independence. Without the appropriate level of funding and support from government, business and the not-for-profit sector, the objectives and effectiveness of the Board will be hindered.

We recommend that either legislation be introduced or the accounting standard AASB 1034 be strengthened, so that a discussion of the role of internal audit, its scope and activities are noted in the financial reports issued by public companies. This would provide the investing public, assurance that the internal control system is continually being assessed to ensure that risks at both the entity level and business unit level are managed properly.

We note that in light of the Enron collapse that there are proposed legislative changes in the US, which will enshrine the SEC's "scope of practice" provisions. This will have the effect of heavily restricting external audit firms from providing internal audit services to audit clients.

It is important that the external auditor is independent of its client and as AUP 32<sup>1</sup> points out "internal audit is an integral part of an entity's organisation and functions under the policies established by the governing body with the objective of assisting that body in the effective discharge of its responsibilities."

When performed in accordance with the Institute's *Standards for the Professional Practice of Internal Auditing*, internal auditing is integral to the operations of the organisation. Internal auditors form a vital part of the internal control structure within the organisation in which they operate.

Therefore, when an external auditor performs a total, comprehensive program of internal audit as well as the attest function to the financial statements, the external auditor would effectively be in a position when its own work would be audited. Furthermore, in our view an external auditor will not be able to objectively comply with *Australian Auditing Standard 604*.

*Australian Auditing Standard 604* "Considering the work of internal auditing"<sup>2</sup> requires the external auditor to assess the effectiveness of the internal auditing function and the impact (if any) on control risk.

The external auditor is required to assess:

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<sup>1</sup> Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, February 1999, "AUP 32 Audit Independence", paragraph 45. Note that this professional Statement serves as guidance only and does not require mandatory compliance.

<sup>2</sup> Auditing Standards Board of the Australian Accounting Research Foundation (October 1995), "AUS 604 – Considering the Work of Internal Auditing". Note that compliance with the black letter clauses in the Standard (as paraphrased above) is mandatory for members of the Institute of Chartered Accountants in Australia and CPA Australia.

- the organisational status of internal auditing in the entity and the effect this has on its ability to be objective;
- scope of internal auditing – nature and extent of the assignments which internal auditing performs;
- technical competence – whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors and
- professional care – whether internal auditing is properly planned, supervised, reviewed and documented.

Where the external auditor performs the internal audit function within an organisation, it is highly doubtful that an external auditor will criticise its own internal audit services say, due to insufficient scope, incompetent execution or for lack of professional care. In other words, objectivity in assessing the internal audit function – a function which we believe plays a significant role in corporate governance, risk management and the overall internal control structure – **could** be dramatically impaired.

## RECOMMENDATIONS

*To enhance the accountability of public and private sector auditing the IIA-Australia recommends*

### Outsourcing

1. External auditors (registered company auditors) of an organisation should not be permitted to undertake Internal Audit or any other consultancy for the same organisation. This is to ensure that any possibility of a conflict of interest arising is avoided and to ensure that the internal audit function maintains its independence.

*If this recommendation is not accepted then*

- 1.1. It should be reported in the Annual Report if Internal Audit is outsourced/co-sourced, to whom and whether the same firm undertakes the external audit; and how independence is maintained in the event of the same firm undertaking internal and external audit functions. See point 7.4.
- 1.2. Audit Committees need to evaluate extended and non-audit services conducted by their audit firm. We recommend that audit committees should be encouraged to evaluate extended audit services and that disclosures in the statutory financial statements should be required in legislation to list and itemise non audit services provided by a firm's external auditors to its audit client. The fees derived from the provision of internal audit services should be a separate category in the list, especially if the internal audit function was to be out sourced either to the external audit firm or to any other firm.
2. Similarly, where the internal audit function is completely outsourced, then the outsourcing firm should not provide other consulting services, including external audit. This is to ensure that independence is maintained.

*If this recommendation is not accepted then*

- 2.1. It should be reported in the Annual Report if Internal Audit is outsourced/co-sourced, to whom and whether the same firm undertakes the external audit; how independence is maintained in the event of the same firm undertaking internal and external audit functions. See point 7.4.

### Audit Committee

3. That it be mandatory for all publicly listed companies to have an Audit Committee. The Audit Committee's responsibilities would be those as

detailed in the *Audit Committees Best Practice Guide*.<sup>3</sup> It should be the Board Audit Committee that sets the scope of the internal audit, with the assistance of the head of internal audit, not the CEO or other members of the senior management team. A means of assisting this process is to have a rolling Internal Audit plan of review which incorporates those areas to be reviewed annually, biannually etc.

4. That the Audit Committee be comprised of non-executive directors only. The Chief Financial Officer, the Chief Executive Officer and other managers with executive and operational responsibilities should be specifically excluded from the committee and to avoid any conflict of interest, they should attend meetings of the committee by invitation only.

#### Internal Audit Function

5. That it be a requirement for all publicly listed companies to have an Internal Audit function which may be internally/externally sourced, reporting to the Audit Committee. It is essential that when the internal audit function is externally sourced, that the organisation has an internal, Internal Audit management team to define and direct the scope of the work to be undertaken. The Internal Audit management team should be suitably qualified {ie member of the IIA-Australia and/or with the designation CIA (Certified Internal Auditor)}.
6. That internal audit functions within Australian companies adopt the IIA Inc *Standards for the Professional Practice of Internal Auditing*, as they are the standards applied globally by IIA members in over 100 countries.

These standards, being specific to internal audit, should be adopted and not other standards such as those adopted by eg ICAA and CPA Australia. It would be our aim to have the IIA Inc standards adopted as the global standards by IFAC (to which IIA Inc is affiliated) and the International Auditing and Assurance Standards Board.

7. In line with our definition of internal auditing (see page 2, above), the internal audit function as directed by the Audit Committee, must review all aspects of an organisation including corporate governance, risk management, control, assurance etc. This is to avoid any restriction being placed by organisations on the scope of the internal audit function. The internal audit function is independent within the organisation. This independence can only be achieved by reporting directly to the Audit Committee, with the CEO being kept apprised of the process. The internal audit function should not report to the Chief Financial Officer, Director of Corporate Services, or similar.

It should be mandatory that audit committees report against the areas listed

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<sup>3</sup> AARF, AICD, IIA-Australia *Audit Committees: Best Practice Guide* 2<sup>nd</sup> edition, Sydney, 2001

below as a minimum and that they report on the role played by internal audit in each of the four areas below.

For example,

7.1. Risk management

Internal audit should be required to participate in and review the Business Risk Management Strategy of the organisation and to build the Audit Review Program around the key identified business risks.

7.2. Control

The issue of Control Review should be clearly set out in the Audit Committee/Internal Audit Charters so that the management of the organisation is very clear on the access and coverage of the function.

7.3. Assurance

Internal Audit should be empowered to obtain and provide assurance on key aspects of the Business operations and to report accordingly to the Audit Committee.

7.4. Organisational governance processes

Management should be required to formally report on organisational governance processes to the External Auditors and Audit Committee at least annually, usually when the financial statements are being prepared and submitted for sign-off. Internal Audit should be empowered to have oversight and review on the management reporting process on governance. Such reporting should include any areas outside the Balance Sheet including eg items such as derivatives, unusual funding arrangements, risk management issues.

Publicly listed companies should be required to report in their Annual Reports on the Internal Audit function (its structure; use of an Internal Audit charter; to whom it reports; in-house/outsourced/co-sourced; if outsourced/co-sourced, to whom; use of outside expertise; whether a regular, independent evaluation takes place of the adequacy of resources available to the Internal Audit function for it to achieve its objectives; listing of the internal audits conducted in the reporting period; means of access to the audits conducted. These will require amendment to the ASX listing rules).

## Recognition

8. That Internal Audit be recognised as a separate profession from external audit, as the skill base is far more diverse than for external audit; as it has its own *Code of Practice*; its own *Standards for the Professional Practice of Internal Auditing*; and has its own certification (Certified Internal Auditor, which is achieved through examination and relevant experience. Certification

is controlled on an international basis by the Board of Regents, IIA Inc, the parent body of IIA-Australia).

9. That Internal Auditors be registered (in a similar way to External Auditors). It is suggested that the criteria for registration be compiled by the IIA-Australia and ASIC and that supervision of Registered Internal Auditors be conducted by a joint committee of ASIC and IIA-Australia. Internal Auditors would have to be suitably qualified and the qualifications would be set by the IIA-Australia.