

Performance Review

# Internal Audit Capacity in the NSW Public Sector

Final Report



New South Wales Government  
Department of Premier and Cabinet

Performance Review Unit

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ISBN: 978-0-7313-3371-4

Published March 2008

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# 1. Executive Summary

In 2007, a review of Internal Audit Capacity in the NSW Public Sector was conducted by the Department of Premier and Cabinet, Performance Review Unit. The review included both the General Government Sector and State Owned Corporations and involved research; inter-jurisdictional comparisons; surveys of NSW Public Sector agencies; in-depth interviews with Heads of internal audit across the NSW Public Sector and from better practice private sector organisations and; consultation with internal audit professional bodies and other key stakeholders.

## **Key findings of the review are that:**

- at present, there are varying levels of performance across agencies when their internal audit processes are compared with best practice
- while Chief Executive Officers (CEOs) are required to have an effective system of internal control, internal audit is not presently mandated but is to occur 'wherever practicable' (Section 11 (2) of the *Public Finance and Audit Act 1983*)
- there is an uneven capacity of agencies across the sector to use the internal audit function to mitigate service delivery failure and other business risks
- there is a total spend on internal audit across the NSW Public Sector of approximately \$50 million per annum, which is on target with the global benchmark average of 0.1% of expenditure
- there are opportunities to improve the effectiveness of internal audit without increasing the direct costs of the program
- smaller agencies require a greater level of assistance in effectively and efficiently using internal audit
- the increasing trend in the private sector towards greater independence of Audit & Risk Committee is not yet mirrored across much of the public sector (State Owned Corporations perform better in this regard).

## **Key risks of not improving the internal audit function across government are:**

- failing to meet Government commitments due to loss of control, particularly during critical policy, service delivery and business system change
- service delivery failure (e.g. cross agency matters, poor procurement and operations, information communication and technology [ICT] systems)
- increased potential in the General Government Sector for management capture and risks being 'hidden' as responsibility for internal audit is solely with the CEO whereas in State Owned Corporations it is a Board responsibility
- inefficient use of existing resources and potential for maladministration
- lack of reliable information for government decision making (e.g. don't have or can't trust the information available)
- increased opportunities for fraud and corruption, particularly with increased electronic service delivery.

## Key recommendations in the review cover:

- strengthening the whole-of-government policy and regulatory framework for governance of internal audit and risk management as outlined in *Better Practice Framework for Internal Audit* by updating Treasurer's Direction 720 to mandate minimum standards on a 'comply or explain' basis
- monitoring internal audit functions and reporting on compliance with the revised Treasurer's Direction 720, including the *Better Practice Framework for Internal Audit* as part of the NSW Audit Office's compliance audit program
- facilitating a pilot cluster of agencies for the governance, management and delivery of internal audit to maximise the efficiency and effectiveness of existing internal audit resources utilising either a shared service or policy cluster
- updating guidance on internal audit (including common definitions of key terms) in consultation with government agencies and State Owned Corporations and professional associations such as Institute of Internal Auditors (IIA) and Information Systems Audit and Control Association (ISACA)
- establishing audit practitioner and risk management networks to exchange knowledge and expertise on internal audit and risk management including the use of electronic forums. This will ensure the dissemination of best practice across Government and result in savings for agencies through sharing of expertise, practices, procedures and risk management strategies
- developing a strategy for better use of technology for internal audit across the NSW Public Sector
- developing an internal audit human resource strategy.

## The specific terms of reference for the review and relevant findings are summarised below:

### 1. The appropriateness of the current legislative and policy framework relating to internal audit services

- The *Public Finance and Audit Act 1983* does not address internal audit governance and risk management requirements in a contemporary way.
- All other jurisdictions examined have stronger mandated policy requirements for internal audit.
- NSW uses a 'devolved' regulatory model for internal audit.
- Critical elements of internal audit are left to the discretion of each agency.
- Policy framework for internal audit is fragmented and components need updating.
- NSW corruption and fraud prevention guides represent better practice.
- Treasurer's October 2005 response to Public Accounts Committee Review of the Operations of Audit Committees supported updated advice to agencies on better practice for Audit Committees. Mandatory *Guidelines for Boards of Government Businesses* are currently being finalised by Treasury.

- 2. The provision of internal audit services to agencies and whole-of-government arrangements for supporting and delivering such services**
- Quality and capacity of internal audit varies across the sector.
  - There is a need for more active whole-of-government leadership for internal audit.
  - Organisations rely on their own resources and expertise to develop internal audit services and do so working mostly in ‘silos’.
  - Treasurer’s May 2006 response to the Public Accounts Committee *Review of Risk Management* recommended collaboration and a partnership approach to risk management processes.
- 3. The use of internal audit by agencies in advising on the design and application of risk management and anti-fraud practices**
- Internal audit plays an important role in facilitating risk management and anti-fraud practices in government organisations.
  - Many organisations need to improve enterprise risk assessment to better drive internal controls and priorities for internal audit.
  - Organisations generally have a culture of risk management awareness but processes for effective implementation of risk management could be improved in many agencies.
  - Treasurer’s May 2006 response to Public Accounts Committee *Review of Risk Management* indicated the need to update practice guides.
- 4. The structure and operations of Audit Committees**
- Internal audit governance varies across the sector with many organisations not adopting recognised governance best practice.
  - State Owned Corporations follow better practice with Audit Committees comprised solely of independent members.
  - For the General Government Sector and Public Trading Enterprises:
    - 26% have a majority of independent members
    - 63% have independent Chairs
    - 26% have no independent members and common membership with executive management
    - 5% have no Audit Committee.
  - The independence of some Audit Committees may be compromised and therefore some risks could be better identified and managed.
- 5. The reporting and governance arrangements between internal and external audit**
- External audit is using reports prepared by internal audit, but agencies indicated the need for improved coordination of audit planning between internal and external audit.
  - The NSW Audit Office is addressing this issue through attendance at Audit Committee meetings and earlier submission of external audit plans to agencies.
  - Audit Committee Chairs oversee the coordination between external and internal audit in most, but not all, agencies.

**6. The costs of internal audit services from internal agency sources and external providers including the Internal Audit Bureau (IAB)**

- Total NSW Government internal audit spending of approximately \$50 million per annum which is on target with the global benchmark average of 0.1% of expenditure.
- Expenditure is proportionately higher in small and medium agencies (which are 0.5% and 0.2% of expenditure respectively).
- Internal audit activities involve approximately 400 full time equivalent staff (FTE) including outsourced services across the sector representing on average 1 in 1,000 FTE, which is on the global benchmark.
- Overall 73% of internal audit services are resourced in-house and 27% are outsourced, with a lower proportion of outsourcing for larger organisations.
- 12% of organisations use fully in-house internal audit, 38% are partially outsourced and 50% are fully outsourced.

**7. The effectiveness of internal audit practices and the quality and range of services**

- Effectiveness is critically dependent on the quality and capability of audit personnel and there is a current shortage of ICT audit skills.
- Effectiveness is compromised because there is no inter-agency coordination of internal audit strategies and many organisations:
  - have not fully adopted the Treasury better practice guidance
  - could improve control assessment, and performance monitoring of internal audit activities
  - could achieve more timely implementation of all agreed internal audit recommendations
  - could better utilise technology for audit
  - could better manage outsourced internal audit services.
- Effectiveness is improving because there is a trend of moving from detective to preventative activities.

**8. Opportunities to maximise the benefit and minimise the costs of internal audit services provided, including for small to medium sized agencies**

- The review identified opportunities to improve the value adding and cost effectiveness of internal audit without increasing the direct costs of the program (see Section 2 Approved Actions).

## 2. Approved Actions

The following recommendations made by the review of the Internal Audit Capacity in the NSW Public Sector have been approved by the Government.

1. **Strengthening the whole-of-government policy and regulatory framework for governance of internal audit and risk management as outlined in *Better Practice Framework for Internal Audit* by requesting Treasury to update Treasurer’s Direction 720 mandating minimum standards on a “comply or explain” basis (with exceptions to be approved by the portfolio Minister):**
  - a) minimum governance for internal audit requiring Audit & Risk Committee with independent Chair and some independent members (State Owned Corporations have all independent members), with a charter incorporating a dispute resolution mechanism between Audit & Risk Committee and management and access to a central government arbiter as a last resort
  - b) Audit & Risk Committee Chair and independent members selected from a central pre-qualified panel. (Department of Commerce [Commerce] to facilitate and oversee the central panel process)
  - c) Audit & Risk Committee oversight of ‘enterprise’ focused risk management and corruption and fraud prevention
  - d) Audit & Risk Committee recommending selection or replacement of Chief Audit Executive for the internal audit function
  - e) each organisation having enterprise risk management practices consistent with AS/NZ4360 (the existing policy requirement for Results & Services Plans) integrating strategic and operational risk management with internal audit and other assurance activities
  - f) a control effectiveness assessment and risk rating on every audit finding that will determine if management action is required
  - g) a requirement for management agreed action plans from every internal audit
  - h) a requirement for reporting and tracking implementation of audit action plans by management to the Audit & Risk Committee and the CEO/Board, to ensure all agreed audit recommendations are implemented within the agreed timeframe.
2. **NSW Audit Office to monitor internal audit functions and report on compliance with the revised Treasurer’s Direction 720, including the *Better Practice Framework for Internal Audit* as part of its compliance audit program.**
3. **Department of Premier and Cabinet (DPC), Treasury and Commerce to facilitate a pilot cluster for the governance, management and delivery of internal audit to maximise the efficiency and effectiveness of existing internal audit resources utilising either a shared service or policy cluster through:**
  - a) a single Audit & Risk Committee composed of an independent Chair and other members

- b) a single highly skilled audit executive who will manage a pool of audit staff and outsourced audit services on behalf of CEOs
- c) shared and integrated information systems incorporating audit technology.

**4. Treasury, with the support of DPC and Commerce, to update guidance on internal audit in consultation with government agencies and State Owned Corporations and professional associations such as Institute of Internal Auditors (IIA) and Information Systems Audit and Control Association (ISACA):**

- i) *TPP95a Statement of Best Practice: Internal Control and Internal Audit (1995)*. Update to include best practice areas such as:
  - a) alignment with the legislative and policy changes in recommendation 1 above especially in relation to requirements for governance, assessment of control risks and effectiveness, ensuring management action plan implementation, and include definitions of key terms
  - b) strengthening the practice requirements for fraud and corruption prevention
  - c) the need to focus internal audit on control risks of major planned changes, during and after policy, service delivery and business system change
  - d) using references to professional best practice standards as a means of ensuring on-going maintenance of the guide
  - e) practices for managing outsourced internal audit that include cooperative development of management action plans to address control risks identified, formal evaluation, feedback and resolution of audit service performance issues
  - f) requiring Chief Audit Executives to adopt best practice approaches to improve organisational culture for achieving effective controls and performance while retaining an independent/regulatory posture by:
    - o establishing an open working relationship with management using clear rules of engagement and transparent communications
    - o publishing audit assessment and rating methodologies for evidence based findings
    - o consulting with management to identify the solution and actions to address identified problems
    - o undertaking management initiated reviews
    - o providing management with tools for control self assessment.
  - g) ensuring internal audit is appropriately positioned to perform its regulatory role while working with management to improve organisational controls and performance (e.g. using forums such as the Chief Executives Committee, CEO Cluster Committees and the CEO Network)
  - h) requiring periodic review is undertaken of internal audit functions using external resources or industry self assessment tools.
- ii) *TPP95b Control Assessment (1995)*. Revoke as its practices will be covered in the revised TPP95a.
- iii) *TPP97-3 Risk Management and Internal Control (1997)*. Update to align with recommendations adopted from the review, the revised TPP95a and

the Australian Standard for Risk Management (AS4360) which Treasury has already adopted as a recommended standard for use by NSW Government entities.

- 5. Treasury, with the support of DPC and Commerce, to facilitate the establishment of audit practitioner and risk management networks to exchange knowledge and expertise on internal audit and risk management including the use of electronic forums. This will ensure the dissemination of best practice across Government and result in savings for agencies through sharing of expertise, practices, procedures and risk management strategies.**
  
- 6. Commerce with the support of Treasury and DPC, and input from the NSW Audit Office, to develop a strategy for better use of technology across the NSW Public Sector for:**
  - a) centralised access to enterprise information to reduce the need for internal audit resource time in site visits
  - b) audit management to improve the administration and performance reporting of audit activities
  - c) continuous process monitoring to provide tools for management to identify high risk or exceptional transactions
  - d) computer-assisted audit techniques (CAAT) for data mining and matching for audit checks
  - e) making control self assessment available for use by management
  - f) enterprise risk management to record, quantify, assess, control, communicate and monitor risks.

This can be supported through Commerce's ICT reform initiatives (e.g. Back Office Application Consolidation - BOAC).

- 7. Public Sector Workforce Office (PSWO), DPC and Treasury, via the Accountancy Strategy Group or similar, to develop an internal audit human resource strategy for consideration at Chief Executives Committee (CEC) by November 2008 to:**
  - a) retain and improve internal audit seniors and audit specialists across the NSW Public Sector by:
    - o structuring a program to rotate career auditors through government organisations
    - o encouraging professional development for internal audit staff and Audit & Risk Committee members.
  - b) acquire high quality staff for auditor roles by:
    - o a whole-of-government approach to using internal audit as an entry point for graduates with management potential, including accessing the pilot Fast Track graduate recruitment initiative
    - o developing a recruitment capability set for internal auditors which includes strong interpersonal, communication and analytical skills
    - o developing a strategy to specifically target ICT skills for development of ICT auditors, as this is increasingly a required skill-set
    - o rotating staff from the organisation through internal audit as part of management training.

- c) coordinate internal audit training needs including:
  - auditor induction and training
  - management of outsourced internal audit activities
  - CEO understanding of internal audit role
  - role and responsibilities for Audit Committee members
  - professional development for audit staff.

**8. Release this review report on internal audit capacity within the NSW Public Sector and to key stakeholders.**

# 3. Terms of Reference and Review Personnel

## 3.1 Objectives of Review

The objectives set for the review of Internal Audit Capacity in the NSW Public Sector are to:

- assess the current arrangements and operations and identify areas for improvement
- ensure agencies understand the rationale for internal audit and, in particular, link internal audit activities with their annual risk management plan.

## 3.2 Scope of Review

The focus was on ensuring the efficient delivery of internal audit services and identifying opportunities for cost savings.

The review included all agencies within the General Government Sector and all government businesses.

The review was not to include examining the results of external audits undertaken or the performance of entities undertaking such audits.

## 3.3 Terms of Reference

The specific terms of reference for the review were:

1. the appropriateness of the current legislative and policy framework relating to internal audit services
2. the provision of internal audit services to agencies and whole-of-government arrangements for supporting and delivering such services
3. the use of internal audit by agencies in advising on the design and application of risk management and anti-fraud practices
4. the structure and operations of Audit Committees
5. the reporting and governance arrangements between internal and external audit
6. the costs of internal audit services from internal agency sources and external providers including the Internal Audit Bureau (IAB)
7. the effectiveness of internal audit practices and the quality and range of services
8. opportunities to maximise the benefit and minimise the costs of internal audit services provided, including for small to medium sized agencies.

## 3.4 Review Personnel

### Steering Committee

- Mr Byram Johnston, Steering Committee Chair, CEO Mainstream BPO
- Dr Alan Gleeson, Executive Director, Corporate Services, Department of Primary Industries
- Mr Noel Kean, Director, Internal Audit, EnergyAustralia
- Mr Peter Scarlett, Executive Director, Transport Service Group, Ministry of Transport
- Mr Peter Whitehead, Public Trustee, Public Trust Office, Attorney General's Department
- Ms Rose Williams, Senior Director Corporate Management, NSW Treasury
- Mr Graeme Head, Deputy Director General, Performance Review Unit, Department of Premier and Cabinet
- Mr Peter Connelly, Executive Director, Performance Review Unit, Department of Premier and Cabinet

### Review Team

- Mr Mathew Cooper, Review Director, Cooper Consultants Pty Limited (from June 2007)
- Mr Jim Ring, Review Director, Manager Internal Audit, State Transit Authority (until April 2007)
- Mr Kent Broadhead, Principal Project Officer, Performance Review Unit, Department of Premier and Cabinet
- Mr Gordon Eastwood, Principal Project Officer, Performance Review Unit, Department of Premier and Cabinet
- Ms Annie Lau, Principal Project Officer, Performance Review Unit, Department of Premier and Cabinet
- Mr Hugo Harmstorf, Director, Business Improvement Branch, NSW Treasury (until March 2007)

# 4. Review Methodology

The review used the DPC Performance Review Division’s standard methodology to conduct the information collection and analysis of internal audit in line with the review’s terms of reference. The methodology involves the following steps:

- review planning
- research
- business model analysis and issue papers
- survey and comparative analysis
- performance conclusions
- recommendations

## 4.1 Research

Research involved accessing hardcopy and electronic published information, discussions with jurisdictional representatives and subject experts. Sources accessed included professional, research and standards associations, industry network forums, workshops and conferences, private sector internal audit providers, policy and regulatory agencies and industry professionals. Support provided to the review by both public and private sector professionals has been extensive and enthusiastic. The research involved an analysis using twelve performance areas as a framework for collecting information about internal audit activities.

**Table 1: Performance Areas**

Performance Area	Description
1. Environment	SWOT/PEEST analysis, operating context, inter-jurisdictional comparison
2. Clients	Client profile/needs analysis, customer service charters, client consultation, satisfaction surveys/complaints system
3. Stakeholders	Stakeholder profile, relationships analysis, consultative mechanisms
4. Legislation and policy	Legislation, regulations, legislative reviews/policy proposals, Ministerial statements, whole-of-government policies, funding commitments
5. Service delivery	Service planning and profile, service provision, outputs costing, pricing policy, service performance/benchmarking
6. Strategies and reviews	Governance, planning and review, performance agreements, business model, internal and external reviews and audits
7. Culture	Cultural profile, values and ethics statement, code of conduct, staff climate survey, management and leadership profile, change management plan
8. Communications	Reports, website, publications, intranet, telephone, correspondence tracking, staff meetings/circulars/newsletters, records management
9. Organisational structure	Organisation structure, job descriptions, delegations, accountability
10. Human resources	Workforce profile and planning, gap analysis, staff appraisals, training and development programs, OHS plan, industrial relations
11. Processes and systems	Process maps, procedure manual, business process re-engineering, servicing agreements, ICT plans, TAM plan, shared corporate services
12. Controls and metrics	Performance reporting, risk management, internal controls, ABC, FIS, MIS, asset management plan, corporate overhead analysis

*Source: Council on the Cost and Quality of Government Review Methodology*

The research identified the subject matter for the business model analysis and issues for further investigation.

## 4.2 Business Model Analysis

The business model analysis was a critical part of the review. Together with the better practice research, the business model analysis provided a framework that has been used as the basis for the surveys, comparative analysis and performance assessments in the second part of the review.

## 4.3 Survey and Comparative Analysis

Primary data for the review was collected from (i) all public sector organisations including State Owned Corporations and (ii) a sample of 24 organisations. The data collection involved three structured questionnaires and also face-to-face interviews.

### Surveys

- 1. Whole-of-Government:** Survey 1 *Internal Audit Costs* was sent to all NSW General Government Sector, Public Trading Enterprises (PTEs) and State Owned Corporations (SOCs). Responses were received from 89% of organisations representing 99% of Government expenditure. It collected FTE numbers and cost information for internal audit activities.
- 2. Survey of Internal Audit Resources and Practices:** Surveys 2 and 3 examined internal audit resources and practice information. The surveys were sent to 24 sample agencies representing 63% of total NSW Public Sector expenditure. The 24 sample organisations included:

**Table 2: Surveyed Agencies by Size and Sector**

Size of Agency	Number of Agencies		
	General Govt	PTEs	SOCs
<b>Large</b> (Organisations with expenditure \$300m and over)	10	-	2
<b>Medium</b> (Organisations with expenditure between \$50m and \$300m)	4	2	2
<b>Small</b> (Organisations with expenditure under \$50m)	3	1	-

Survey 2 *Chief Audit Executive* included 34 questions about internal audit resources, profile of activities and internal audit practices and sources of audit knowledge. Survey 2 was sent to the Chief Audit Executive and returned completed for all 24 organisations in the selected sample.

Survey 3 *Audit Committee Chair* included 44 questions about internal audit governance, audit practices, sources of audit knowledge and internal audit performance. Survey 3 was sent to the Chair of the Audit Committee and returned completed for the 24 organisations in the selected sample.

## Interviews

Survey 2A *Interview for the Chief Audit Executive*. A standard questionnaire was used to explore aspects and practitioner views of internal audit practices that could not be obtained through the structured survey questions. The interviews covered:

- NSW Public Sector — 20 of the 24 organisations in the sample
- Private Sector — 6 private sector organisations that are considered to use best practice.

## Comparative Analysis

The survey and interview results were used for the comparative analysis. The desk research information and interviews with the private sector were used to prepare a description of a better practice model for internal audit — first using the standard twelve methodology performance areas and then using the identified business model for internal audit.

The better practice framework was then used as the basis for comparative analysis for jurisdictions, agencies, regulatory models and service delivery options for internal audit.

## 4.4 Performance Conclusions

The analysis from all phases of the review was used to reach performance conclusions on internal audit for the NSW Public Sector.

## 4.5 Recommendations

Recommendations were developed from the performance conclusions. The recommended actions were tested and refined in consultation with key stakeholders in the review, namely, NSW Treasury, Chief Executives Committee, the NSW Audit Office and the Review Steering Committee.

# 5. Analysis of Internal Audit

## 5.1 Defining Internal Audit

To provide a consistent framework for all aspects of the review, internal audit and its components were defined. The review recommended including agreed definitions in Treasury Guidelines and sector-wide standards to promote greater consistency with the internal audit function.

**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. (Source: Institute of Internal Auditors)

**Governance** is the combination of processes and structures implemented by the Board (or equivalent) in order to inform, direct, manage and monitor the activities of the organisation toward the achievement of its objectives. (Source: Institute of Internal Auditors – *International Standard for Professional Practice*)

**Risk management** is a logical and systematic method of establishing the context, identifying, analysing, evaluating, treating, monitoring and communicating risks associated with any activity, function or process in a way that will enable the organisation to minimise losses and maximise opportunities. (Source: *AS/NZS 4360 – Risk Management*)

**Internal control** is a process, affected by an entity's Board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- reliability and integrity of financial and operational information
- compliance with applicable laws, regulations and policies
- safeguarding of assets
- effectiveness and efficiency of operations.

(Source: Institute of Internal Auditors – *International Standard for Professional Practice*)

The American Committee of Sponsoring Organisations of the Treadway Commission (COSO)<sup>1</sup> developed a model for evaluating internal controls. This model has been adopted as the generally accepted framework for internal control and is widely recognised as the definitive standard against which organisations measure the effectiveness of their systems of internal control.

The components of internal control described in the COSO model are shown in the table below.

<sup>1</sup> COSO model was developed in 1992.

**Table 3: Components of Internal Control**

Internal Control Components	
<b>Control environment</b>	The core of any business is its people – their individual attributes, including integrity, ethical values and competence – and the environment in which they operate. They are the engine that drives the entity and the foundation on which everything rests.
<b>Risk assessment</b>	The entity must be aware of and deal with the risks it faces. It must set objectives, integrated with service delivery and corporate management so that the organisation is operating in concert. It also must establish mechanisms to identify, analyse and manage the related risks.
<b>Control activities</b>	Control policies and procedures must be established and executed to help ensure that the actions identified by management as necessary to address risks to achievement of the entity's objectives are effectively carried out.
<b>Information &amp; communication</b>	Surrounding these activities are information and communication systems. These enable the entity's people to capture and exchange the information needed to conduct, manage and control its operations.
<b>Monitoring</b>	The entire process must be monitored, and modifications made as necessary. In this way, the system can react dynamically, changing as conditions warrant.

The concept of 'governance' is a term that can be understood to mean different things to different people. These were identified as being the difference between the governance process as used by corporate entities and the governance function.

The Australian Standard on Corporate Governance (AS8000-3 and HB400-1) describes the governance process which includes the three components of (i) governance function directing corporate activities, (ii) risk management processes and (iii) the controls applied to treat the risks identified through the risk management process. These three components were identified as the basis of the internal audit framework to be used throughout the review.

Governance is a key focus for audit activities worldwide, so it was important to understand the attributes that are required for an effective governance function. From its research, the review identified three key characteristics.

### Governance Function

- 1. Direction:** meaning leadership and management by setting the strategic focus, policy, instructions and allocation of resources to achieve the organisation's objectives, and communicating and regulating the course of action to achieve those objectives.
- 2. Structure and accountability:** meaning the organisation and delegation of performance responsibility.
- 3. Monitoring:** meaning obtaining and using feedback information necessary for effective direction of activities.

An example of the need for clear definitions is highlighted in the attachment to the NSW Treasurer's May 2006 response to the Public Accounts Committee Report 12/53 *Risk Management in the NSW Public Sector*. Item 2 in the attachment states:

*The Terms 'corporate governance', 'internal control' and 'risk management' all refer to organisational processes that ensure effective management accountability in the broad area of oversight. The terms are used interchangeably at times, and their definitions overlap in many cases, e.g. sound risk management is sometimes categorised as an important element of an internal control regime.*

## **Categorising Control Activities**

Two terms identified by the review as needing clarification are 'Soft Controls' and 'Hard Controls' in relation to control activities utilised by an organisation.

1. **Soft controls** involve 'indirect' activities to influence people to satisfy the performance objectives of the organisation. These activities include:
  - the setting and publishing of ethics statements and codes of conduct
  - promoting values such as openness, shared values, clarity, commitment to competence, honesty, high expectations and communications
  - training for fraud prevention
  - identifying and ethical handling of actual or apparent conflicts of interest between personal and professional relationships
  - training in policies and procedures used by the organisation.
2. **Hard controls** involve 'direct' activities to ensure compliance with the performance objectives of the organisation. These activities include:
  - management information and performance reporting
  - inspections, physical counts, reconciliations
  - supervision
  - procedures
  - reporting structure and limits of authority
  - access security, user-identification and passwords
  - reviews.

## 5.2 Business Context of Internal Audit

Effective internal audit is needed to assure that an organisation's financial and service delivery risks are being controlled. It assures reliable information, regulatory compliance and optimal operational performance.

The business context for internal audit was consistent in all organisations consulted as the '3<sup>rd</sup> Line of Defence' in assuring the performance of the organisation. Service delivery managers are the '1<sup>st</sup> Line of Defence' in managing risks and applying controls, operational assurance services with reports to executive management are the '2<sup>nd</sup> Line of Defence' and internal audit services which report independently to the Board/CEO via the Audit & Risk Committee are the '3<sup>rd</sup> Line'. This is shown in the figure below.

**Figure 1: Internal Audit as 3rd Line of Defence**



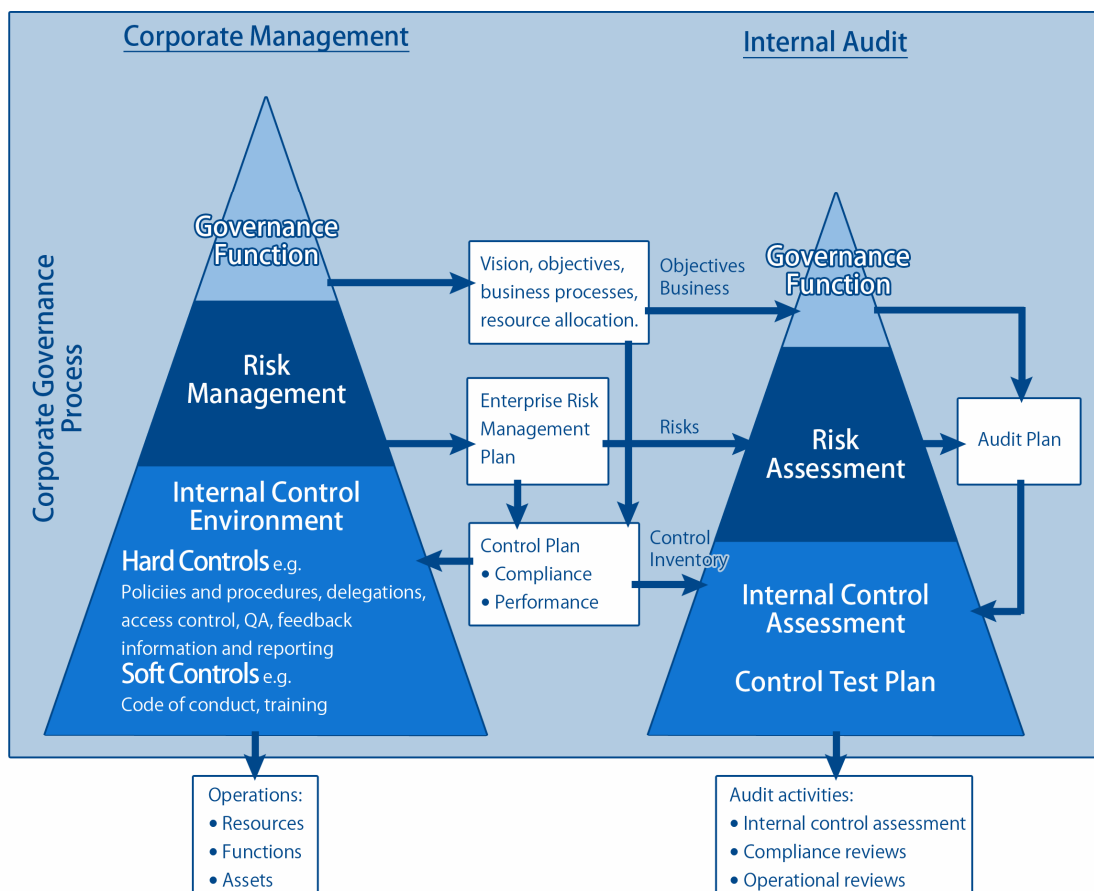
## 5.3 Internal Audit Business Model

Internal audit is integral to an organisation’s governance. Figure 2 outlines the relationship between corporate management and the internal audit function and the key planning instruments developed by management which inform the work of internal audit. The corporate governance process is based on three key components which are mirrored in the internal audit function: (i) governance function, (ii) risk management and (iii) internal controls.

The management of an organisation has responsibility for setting overall corporate strategy and directions and is accountable for operations. The organisation’s Board (or in the Government sector the Chief Executive) is responsible for establishing and maintaining an effective internal audit function, but internal audit must be sufficiently independent in order that it can objectively assess management’s decisions and advise on options to address identified governance, risk management and control issues. It is management’s responsibility to address those issues identified by Internal Audit subject to the risk categorisation.

Best practice indicates internal audit should have independence from operational management. This provides a transparent process to ensure governance is effective, risks are appropriately identified and managed, and the control environment is adequate.

**Figure 2: Internal Audit Business Model**



Internal auditors develop an audit plan with audit tasks to be undertaken each year to assess the implementation of overall corporate governance. This will vary in each organisation depending on the level of maturity of the business, its governance arrangements, the effectiveness of its control environment and the types of risk encountered. Audit activities include internal control assessment, compliance and operational performance reviews.

The key elements of the internal audit business model which mirror management's corporate governance processes are:

- **Governance function**

*Corporate Management* sets the foundations of good corporate governance. Corporate strategy is determined by management via the setting of visions, objectives, corporate plans, business processes and functions and making resource allocation decisions.

*Internal Audit* is the 3rd line of defence (as noted in Figure 1) and involves reviewing the appropriateness of corporate strategy and performance of agency systems and operations. As such, it is the primary assurance function in an organisation.

- **Risk management**

*Corporate Management* implements appropriate risk management to identify and manage risks so organisational objectives are met. Enterprise risk management plans identify and prioritise key risks across the organisation and set mitigation strategies.

*Internal Audit* assesses whether the enterprise risk management planning and implementation are effective.

- **Internal controls**

*Corporate Management* develops, implements and operates internal controls appropriate to the risks identified. These include 'hard' controls such as policies, procedures, delegation, reporting and 'soft' controls such as code of conduct, values and ethical standards. It is the role of management to ensure performance and compliance standards prescribed in a control plan are adhered to.

*Internal Audit* assesses the internal control environments by developing an internal control test plan to evaluate whether control planning and its implementation are effective in terms of both compliance and performance across the organisation.

## 5.4 Internal Audit Better Practice Framework

The business model, research and interview feedback was used to develop a *Better Practice Framework for Internal Audit*. The framework contains two key better practice requirements for whole-of-government policy and regulation of internal audit, and ten key better practice requirements for agencies. The review recommends adoption of the framework by the NSW Government.

**Table 4: Better Practice Framework for Internal Audit**

Component	Better Practice
<b>Whole-of-Government</b>	
<b>1. Governance</b> (internal audit policy and regulation)	<p><b>1.1. Internal audit policy and regulatory expectations:</b> Clear internal audit policy direction and leadership, practice standards set and mechanism to ensure compliance with those standards.</p> <p><b>1.2. Compliance assurance:</b> Monitoring and regulation of compliance with legislation and policy.</p>
<b>Agency</b>	
<b>2. Governance</b>	<p><b>2.1. Independent audit committee:</b> Independent Chair and other independent members with independent panel appointing members.</p> <p><b>2.2. Independence of the internal audit function:</b> A quality internal audit function requires independence from operational management and knowledge to effectively manage the function.</p> <p><b>2.3. Internal audit reporting:</b> Established methodologies for control effectiveness assessment, audit findings risk rating to determine issues for management action; and active monitoring and enforcement of agreed solutions.</p>
<b>3. Risk management</b>	<p><b>3.1. Risk management oversight:</b> Charter for the Audit Committee includes oversight of risk management.</p> <p><b>3.2. Integrated risk management practices:</b> Strategic and operational risk management is integrated across the organisation and with internal audit and other assurance activities.</p> <p><b>3.3. Risk based audit:</b> Internal audit activities are based on the enterprise's integrated risk management and planned controls.</p>
<b>4. Control audit</b>	<p><b>4.1. Audit activities:</b> Appropriate range of efficient activities for effective achievement of internal audit objectives. Activities encompass hard and soft controls, pre-emptive audits for change risks, performance improvement and coordination with other assurance activities.</p> <p><b>4.2. Audit resources:</b> Auditors and the staff managing an internal audit function have both the inherent skills (e.g. inter-personal, analytical and communication) and knowledge (e.g. audit, business and specialist) to effectively undertake internal audit services.</p> <p><b>4.3. Audit processes and systems:</b> Documented audit practices based on externally recognised better practice. Relevant technology is utilised to maximise audit and control effectiveness. Partnership approach between audit and management to improve performance and achieve business objectives.</p> <p><b>4.4. Currency of audit knowledge:</b> Access to and active use of audit "thought leadership", exchange and sharing of knowledge, expertise and audit strategies to ensure ongoing effectiveness of the audit function.</p>

## 5.5 Inter-jurisdictional Comparison

The criteria for the inter-jurisdictional comparison were selected from the *Better Practice Framework for Internal Audit*. The comparative attributes selected are:

- mandatory requirement for internal audit function
- mandatory Audit Committee
- mandatory minimum governance requirements for Audit Committee
- required standards for internal audit activities
- internal audit reporting
- required internal audit link with risk management.

NSW performance is compared with other jurisdictions as outlined in the table following.

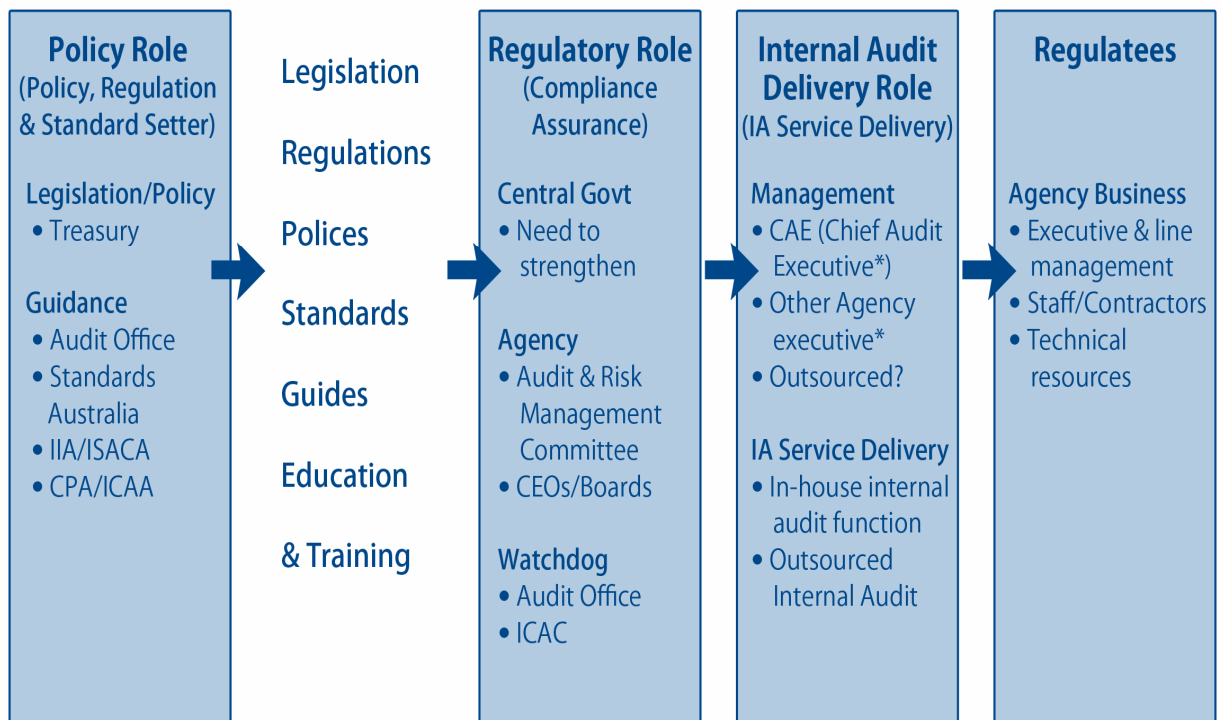
**Table 5: Inter-jurisdictional Comparison of Internal Audit Requirements**

Requirement	NSW (Govt)	VIC (Govt)	Qld (Govt)	Cwth (Govt)	Canada (Govt)	UK (Govt)	ASX (listed companies)	USA (listed companies)
<b>Mandatory requirement for internal audit function</b>	<b>No</b> Wherever practicable, maintain an Internal Audit organisation	<b>Yes</b> Unless exemptions obtained	<b>Yes</b> Responsibility of Accountable Officer	<b>Yes</b> Through mandatory requirement on Audit Committee	<b>Yes</b> Through policy on IA issued by Comptroller General	<b>Yes</b> CEO responsibility	<b>Yes</b> If not, need full disclosure and explanation on departure	<b>Yes</b> Prescribed by the New York Stock Exchange
<b>Mandatory Audit Committee</b>	<b>No</b>	<b>Yes</b>	<b>No</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b> As above	<b>Yes</b>
<b>Mandatory minimum governance requirements for Audit Committees</b>	<b>No</b>	<b>Yes</b>	<b>Yes</b> If Audit Committee in place	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>	<b>Yes</b>
<b>Standards for internal audit activities</b>	<b>No</b> No mandatory standard but outlined in 1995 Treasury Best practice guideline TPP95a	<b>Some</b> Mandatory requirements	<b>Yes</b> Mandatory requirements in Financial Management Standards	<b>Updated</b> Better practice guides, non mandatory	<b>Yes</b> Mandatory requirements by Comptroller General	<b>Yes</b> Mandatory requirements in Government Internal Audit Standards	<b>No</b> No minimum requirements set	<b>Yes</b> Through issue of auditing standards for internal control over financial reporting
<b>Internal audit related reporting</b>	<b>No</b> No requirements	<b>Yes</b> Report on compliance to Minister for Finance	<b>Yes</b> Annual reporting to CEOs from Audit Committee (if in place); regular reporting from IA	<b>Yes</b> CEOs to issue Certificate of Compliance	<b>Yes</b> Internal audit plans, CAE opinion on controls, Audit Committee annual report, all IA reports	<b>Yes</b> CEOs to sign Statement of Internal Control	<b>No</b> No requirements	<b>Yes</b> Sarbanes-Oxley Act section 404 requires internal control report annually
<b>Linkage with risk management</b>	<b>No</b> No mandatory link, but shown in 1995 Treasury best practice guideline TPP95a	<b>Yes</b> IA to address agency risk profile and comply with sector-wide risk management framework	<b>Yes</b> Audit & Risk Committee must address risk	<b>Yes</b> ANAO model Audit Committee charter includes risk management as key responsibility	<b>Yes</b> IA and Audit Committee must address risk	<b>Yes</b> Through issue of Statement of Internal Control which also includes risk management issues and practices	<b>Yes</b> ASX Principle 7 Recognise and Manage Risk requires documented risk management and internal control model	<b>Yes</b> Through Sarbanes-Oxley Act and COSO best practice model produced after Treadway Commission

## 5.6 Regulatory Model for Internal Audit in NSW Public Sector

The diagram below shows the regulatory model roles and resources for internal audit in NSW. There is a noticeable gap in assessing compliance with existing regulations relating to internal audit.

**Figure 3: Regulatory Model for Internal Audit in NSW Public Sector**



Note: \*The CAE is often the Chief Financial Officer

## 5.7 Regulatory Models for Internal Audit

The different regulatory models that can be used for internal audit are described below.

The review identified that the NSW regulatory model aligns with the 'Devolved' model in the table. To address the identified gaps in NSW regulatory settings for internal audit, it is proposed that there be an increase in the mandatory requirements for internal audit. This will move NSW to a 'Directed' model.

**Table 6: Internal Audit Regulatory Models**

Models	Model Description	Policy Role	Regulatory Role	Internal Audit Delivery Role
<b>Unregulated</b>	No centrally imposed policy or practice requirements	<ul style="list-style-type: none"> <li>No centrally prescribed policies / standards</li> <li>Agency determines own policies / standards</li> </ul>	<ul style="list-style-type: none"> <li>Self monitoring against adopted policies / standards</li> </ul>	<ul style="list-style-type: none"> <li>No central involvement in IA service delivery</li> <li>Agency determines IA service delivery</li> </ul>
<b>Devolved</b>	Governance and requirements for internal control devolved to CEO/Board	<ul style="list-style-type: none"> <li>Minimal mandatory policies / standards</li> <li>Centrally provided optional guidelines</li> <li>Agencies determine own policies / standards</li> </ul>	<ul style="list-style-type: none"> <li>No central monitoring of IA compliance or performance of agency</li> <li>Compliance assurance devolved to CEO or Board</li> <li>Audit Committee is optional</li> </ul>	<ul style="list-style-type: none"> <li>Panel of IA service providers for use at agency discretion</li> <li>Agency discretion on IA delivery methodology (better practices and standards)</li> </ul>
<b>Directed</b>	Centrally prescribed governance and practice requirements	<ul style="list-style-type: none"> <li>Mandatory requirements (policies / standards)</li> <li>Active promotion of IA standards and guidelines</li> </ul>	<ul style="list-style-type: none"> <li>Central monitoring of IA compliance of agency</li> <li>Mandated requirement for independent Audit Committee</li> <li>Mandated self monitoring of compliance</li> </ul>	<ul style="list-style-type: none"> <li>Panel of IA service providers for use at agency discretion</li> <li>Central involvement in encouraging effective IA shared services for agencies (e.g. clusters and for small / medium agencies)</li> </ul>
<b>Centralised</b> <sup>(a)</sup>	Centrally controlled and matrix managed internal audit	<ul style="list-style-type: none"> <li>Mandated comprehensive policy and standard setting for IA</li> </ul>	<ul style="list-style-type: none"> <li>Dual accountability to central agency and line agency CEO/Board</li> <li>Central direction and monitoring of agency IA compliance and performance (including IA reporting)</li> </ul>	<ul style="list-style-type: none"> <li>Matrix management involving central direction in IA service delivery</li> <li>Provision of IA shared services for small / medium sized agencies (e.g. clusters)</li> </ul>

Note: (a) The private sector organisations interviewed used the centralised model of internal audit, as does the Canadian Government.

## 5.8 Regulations and Guidance for Public Sector Organisations in NSW

There are a significant number of guides available in NSW relating to internal audit. An overview of these documents is given in the table below. The full list of individual guides available from sources like IIA and ISACA is not shown in the table. The existing regulatory instruments for internal audit in NSW include few mandatory requirements.

**Table 7: Internal Audit Requirements and Guidance**

Organisation	Instrument	Mandatory or Guide
<b>Treasury</b>		
NSW Legislation	Public Finance and Audit Act, 1983	Mandatory
	Annual Reports (Departments ) Act 1985	Mandatory
	Annual Reports (Statutory Bodies) Act 1984	Mandatory
NSW Regulation	Annual Reports (Departments) Regulation 2005	Mandatory
	Annual Reports (Statutory Bodies) Regulation 2005	Mandatory
Treasurer's Directions	<b>720</b> Internal Controls and Audit	Mandatory
	<b>730-750</b> Internal Controls for Computer Based Financial Systems	Mandatory
Guides	<b>TPP95a</b> Statement of Best Practice - Internal Control and Internal Audit (1995)	Guide
	<b>TPP95b</b> Internal Control Assessment (1995)	Guide
	<b>TPP97-3</b> Risk Management and Internal Control Toolkit (Vol. 3 and 4 not available on website) (1997)	Guide
	<b>TPP00-4</b> The Financial Management Framework for the General Government Sector (2000)	Guide
	<b>TPP06-9</b> What you do and why – An agency guide to defining results and services (2006)	RSPs are mandatory. RSPs must disclose key risks for agencies and how treated
	<b>TPP07-8</b> Guidelines for Board of Government Businesses	Government Businesses covered by the <i>Commercial Policy Framework</i> on a 'comply or explain' basis
	<b>TAM04-12</b> Total Asset Management – Risk Management Guideline (2004)	Guide, although legislation may require risk management plans for some projects
Circulars	<b>TC07/12</b> Annual Reporting Update	Guide
	<b>TC07/14</b> Ownership of Internal Audit Documentation (2007)	Mandatory
<b>Treasury Managed Fund</b>	TMF Guide to Risk Management – The RCCC Approach (2005)	Guide
<b>NSW Audit Office</b>	Fraud Control – Current Progress and Future Directions (2005)	
	Fraud Control Improvement Kit (2006)	Guide
<b>Standards Australia</b>	AS/NZS4360:2004 – Risk Management	Guide
	HB436:2004 – Risk Management Guidelines	Guide
	HB158:2006 – Delivering Assurance Based on AS/NZS4360:2004 Risk Management	Guide
	HB254:2005 – Governance, Risk Management and Control Assurance	Guide - Focus is on overall governance of organisations
<b>ASX</b>	Revised Corporate Governance Principles and Recommendations	Applies to publicly listed companies only
<b>IIA - Institute of Internal Audit</b> <b>ISACA - Information System Audit and Control Association</b> <b>RMA - Risk Mgmt Association</b>	Professional Practices Framework (The International Standards for the Professional Practice of Internal Auditing) Includes both Standards and more extensive Practice Advisories <b>NB.</b> IIA adopts relevant practices from other professional associations, by agreement	Standards apply to members.
<b>CPA</b>	Enterprise-wide Risk Management – Better Practice Guide for the Public Sector	Guide

**Table 7: Internal Audit Requirements and Guidance (continued next page)**

**Table 7: Internal Audit Requirements and Guidance (continued)**

Organisation	Instrument	Mandatory or Guide
Cwth Auditing and Assurance Standards Board	ASA610 – Considering the Work of Internal Audit	Mandatory. External Auditors under the Corporations Act must consider the work of IA. AO chooses to follow this
DPC	Strategic Management Framework	Outline of provisions
Department of Local Government (NSW)	Internal Audit Guidelines for Local Government (draft, expected to be released in 2008)	Guide. Councils encouraged to use.

The NSW Department of Local Government (DLG) has identified that there are no legislated requirements for local government in NSW to use internal audit for compliance assurance on Council activities. DLG is currently addressing this issue and, as a first step, has developed *Internal Audit Guidelines* for Local Government. The manual has been jointly developed with the Institute of Internal Auditors and the Internal Audit Bureau.

## 5.9 Internal Audit Activities

The review analysed the audit activities in a four-sector view; three internal audit sectors and the fourth sector is external audit (as defined by the audit activity below). The three internal audit sectors are:

- a) core internal audit
- b) operational audit of corporate management
- c) operational audit of service delivery activities.

The other dimension in the four-sector view is the internal audit activity categorised by the control objectives based on the IIA definition of internal control. This provided the categorisation of activities for the review survey of costs. The activity categories are shown in the table below.

### Activity categories for internal audit time spent

**Table 8: Internal Audit Activities**

Sector	Internal Audit Activity
(a) Core internal audit	1. Reliability of financial information and reporting 2. Statutory compliance
(b) Operational audit of corporate management	3. Review of governance arrangements and processes 4. Corruption and fraud prevention 5. Risk management review 6. Reliability of management information, reporting 7. Compliance with corporate policies, regulations and legislation 8. Guardianship of assets
(c) Operational audit of service delivery activities	9. Effectiveness and efficiency of corporate management activities 10. Reliability of service delivery information, reporting 11. Compliance with policies & regulations for service delivery 12. Management of service delivery assets 13. Effectiveness and efficiency of service delivery
Pro-rata	14. Audit planning and management
Mapped	15. Other

A weighted average of the internal audit cost and time allocation information collected in Surveys 1 and 2 was mapped to sectors a, b and c. The cost of external audit was provided by NSW Treasury from their Treasury Online Entry System reporting. The resulting four-sector view of audit follows.

**Table 9: Analysis of Audit Expenditure in NSW Public Sector**

**Costing based on financial expenditure for 2005-06**

Core Audit Services		Operational Audit Services		
<b>Internal audit cost</b>	<b>\$7.9 million</b>	<b>Internal audit cost</b>	<b>\$30.5 million</b>	<b>Internal Focus</b>
<b>Activity profile</b>		<b>Activity profile</b>		
Audit planning management	2%	Audit planning management	6%	
Reliability of financial information and reporting	9%	Compliance with corporate policies, regulations	18%	
Statutory Compliances	5%	Corruption and fraud prevention	10%	
<hr/>		Risk management review	7%	
<b>Total</b>	<b>16%</b>	Effectiveness and efficiency of corporate management	8%	
		Review of governance arrangements and processes	4%	
		Reliability of management information, reporting	4%	
		Guardianship of assets	4%	
		<b>Total</b>	<b>61%</b>	
<b>External audit</b>	<b>\$29.3 million</b>	<b>Internal audit cost</b>	<b>\$11.6 million</b>	<b>External Focus</b>
		<b>Activity profile</b>		
		Audit planning management	2%	
		Effectiveness and efficiency of service delivery	7%	
		Compliance with policies and regulations of service delivery	6%	
		Management of service delivery assets	4%	
		Reliability of service delivery information, reporting	2%	
		Other	2%	
		<b>Total</b>	<b>23%</b>	

## 5.10 NSW Public Sector Internal Audit Resources

### Expenditure and staffing

NSW Government expenditure on internal audit is approximately \$50 million which is on the global benchmark<sup>2</sup> average at 0.1% of expenditure. Internal audit activities involve approximately 400 FTE (including outsourced services) across the sector representing, on average, 1 in 1,000 FTE.

Overall, 73% of internal audit expenditure is on in-house resources and 27% is outsourced, with the proportion of outsourcing lower for larger organisations. 12% of organisations use fully in-house internal audit, 38% use partially outsourced, and 50% use fully outsourced

89% of in-house internal audit staff have tertiary qualifications. The main disciplines are business/accounting (71%), information technology (6%), legal/arts (5%), engineering/science (3%), social/health/medicine (2%).

Audit related qualifications for NSW Public Sector employed staff are that 6% are Certified Internal Auditors, 6% are Certified Information System Auditors, 22% are members of Institute of Internal Auditors, and 34% are Certified Practising Accountant/Chartered Accountants.

Private sector better practice is increasingly recruiting personnel to train as auditors with a range of multi-disciplinary skills, including a strong emphasis on communications, analysis and an ability to problem solve. This recognises the move of internal audit from a largely financial compliance role to a business improvement role.

## 5.11 Public Sector Best Practice Internal Audit Governance and Operations

Interviews of Chief Audit Executives in the 24 agencies selected for detailed survey showed that internal audit capacity is developing to help mitigate service delivery failure and other business risks in some of these organisations. However, internal audit capacity in organisations is uneven across the sector. The review found that important elements in the *Treasury Statement of Best Practice – Internal Control and Internal Audit (June 1995)* are not always adopted across organisations.

Those internal audit functions with greater capacity have:

- a strategic focus on higher risk areas identified in enterprise-wide risk management
- more open and trusting working relationships with management while retaining their regulatory posture
- internal audit staff with strong interpersonal and communication skills and business knowledge (accounting skills not essential)
- internal audit expertise to effectively manage outsourced audit assignments
- consultative involvement of management to identify solutions and actions to address identified problems

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<sup>2</sup> IIA Global Auditing Information Network (GAIN) 2006 survey.

- control effectiveness assessments and risk rating on every audit finding that determines the priority of management action
- effective reporting and tracking of audit outputs to ensure management action plan implementation
- technology in internal audit activities (e.g. audit management, reporting and action tracking tools, continuous monitoring, data mining and computer-assisted audit techniques)
- worked collaboratively with the external auditor (NSW Audit Office)
- strong links with other assurance functions
- implemented effective fraud and corruption prevention strategies
- control self assessment to assist management in achieving an effective control environment and allow internal audit to shift its focus more on strategic risk rather than compliance issues
- procedures based on recognised standards and practice guides.

## 5.12 Private Sector Best Practice Internal Audit Governance and Operations

The governance and independence requirements for internal audit are well documented in guides for Audit Committees and practice guides published for internal audit. However interviews with the private sector revealed a universal preference for a strongly centralised model for internal audit. Many global corporations interviewed had a *single* top level Audit Committee and internal audit function operating across the corporation's global operations. Teams within the centralised group would specialise in specific areas of the corporation's business, as needed, but would report via a single audit and risk governance structure. The centralisation was the preferred approach to internal audit operations because it ensured:

- audits were independent of local management capture
- utilisation of common best practice methodologies
- consistent standards for audit and assessment of controls and performance
- maximisation of efficient resource development and utilisation (human and technological)
- clear linkage between internal and external audit
- maximisation of audit communication and the benefits of sharing of audit knowledge, strategies and findings.

The six organisations interviewed had turnover in the range \$2 billion to \$47 billion and workforce in the range 6,500 to 94,000 employees. All but one of the organisations had multinational operations.

There were many lessons learned from these interviews which can inform adoption of better practice in NSW. Common themes were:

- audit can involve removing red tape and identifying good business practices as much as ensuring good controls
- strong independent internal audit governance is essential
- evidence based findings rated for risk and control effectiveness
- necessary tracking of management implementation of solutions
- focus on pre-emptive audits on organisational and systems change

- open partnership relationships with management while retaining regulatory stance
- networking between organisations for development of internal audit knowledge and thought leadership
- internal audit practices & procedures based on industry standards
- integrated enterprise risk management approach
- growing use of soft controls
- internal audit function used as a recruitment point for high calibre resources
- extensive use of technology for internal audit.

## 5.13 Technology Resources

All public and private sector organisations interviewed indicated the importance of using technology to support their internal audit activities. Technology provided benefits in improving both efficiency and effectiveness of internal audit, and also in facilitating the provision of information and tools to management for their use in improving the effectiveness of controls in their areas of operation.

The private sector organisations make extensive use of technology and are extending the scope of technology employed in internal audit related activities. The public sector organisations were mostly in the early stages of planning for, or adopting, technology for this purpose.

The technology used in internal audit is for:

- enterprise access to information to reduce the need for internal audit resource time in site visits
- audit management to improve the administration and performance reporting of audit activities
- continuous process monitoring to provide tools for management to identify high risk or exceptional transactions
- publishing of audit information including making control self assessment available for use by management
- computer-assisted audit techniques (CAAT) for data mining and matching for audit checks
- enterprise risk management to record, quantify, assess, control, communicate and monitor risks.

**Enterprise access** to information means utilising wide area networks to access information in operational systems throughout an organisation. This significantly reduces the need for on-site visits. It allows internal audit to remotely access information and pre-qualify subjects for audit leading to significantly improved efficiency and effectiveness of internal audit. It provides a means for sharing audit material with management and supports building an open partnership between internal audit and management in achieving the organisation's objectives.

**Audit management** technology involves audit planning and resource allocation, audit assignment management, templates for audit working papers, audit reporting including sharing of findings with management and their comments and proposed solutions for problems identified; automated summarisation and compilation of reports for different levels of reporting in the organisation; and action plan implementation tracking.

**Continuous process monitoring** technology involves the development of reports within existing operational information systems that can be used by management to identify and investigate transactions with pre-determined risk indication characteristics, and for internal audit to remotely monitor and identify risk areas of the business for audit.

**Publishing of audit information** includes communicating audit methodologies and engagement practices as part of creating an open and good working relationship with management and staff, and providing control self assessment tools to management, so that they can self-assess the effectiveness of their controls. Publishing programs include 'dashboard' reporting of audit activities as part of enterprise management information reporting systems.

**Computer-assisted audit techniques (CAAT)** are applications for data mining, matching and validation for audit checks. These provide powerful electronic tools for both internal audit and operational management. While these tools may be developed by internal audit, they are often provided to operational management for their self monitoring of systems. CAATs can use specialist software applications or can come as standard components within ERP (enterprise resource management) systems.

**Enterprise risk management** systems provide for the development and sharing of risk management information. These systems can include risk registers that categorise strategic and operational risks so that detailed information is available at the business unit level and a high level view of the key risks is available at the corporate level; and 'heat maps of risk by business unit'. Enterprise risk management systems can provide questionnaires for risk self-assessment, loss/incident management, action tracking for recording newly identified risk (such as from internal audit reports) and tracking of remedial actions.

## 5.14 Models for Sharing Internal Audit

The private sector has good business justification for preferring and using the centralised model for internal audit. Internal audit activities represent on average only 0.1% of total expenditure (1 in 1,000 FTE). With approximately 70% of NSW agencies having fewer than 1,000 employees, the review considered the opportunities for sharing of internal audit across multiple agencies.

Economies of scale are important for having the right resources in place to maximise the effectiveness of internal audit for an agency. Outsourcing of internal audit services via the Internal Audit Bureau and other industry service providers is the model that is currently used, but this does not necessarily maximise:

- sharing of audit governance
- coordination of internal audit strategies
- providing small and medium agencies with the expertise to manage the deliverables required from outsourced internal audit services
- sharing of technology opportunities to support multiple agencies.

Economies of scale operate with the internal audit function. NSW has a large number of small agencies. With the target ratio of 1 internal audit staff to every 1,000 FTE staff, many small to medium sized agencies do not have the critical mass and capacity to operate an effective Audit & Risk Committee or prudently manage the internal audit function (whether in-sourced or out-sourced) to better practice standards.

The Internal Audit Bureau (IAB) was established under the *Internal Audit Bureau Act 1985* to provide internal audit, management review and consultancy services to public authorities. It is inappropriate for internal audit service providers (including IAB) to undertake governance of internal audit services for client agencies. Effective governance relies on each agency or cluster having its own capacity to manage outsourced internal audit services.

Cluster arrangements for small and medium agencies provide the opportunity to maximise the effectiveness of internal audit and risk management by sharing:

- a single Audit & Risk Committee with an independent Chair and membership that complies with best practice and report to each CEO separately
- a capable Chief Audit Executive as 'cluster-wide' audit manager to ensure delivery of best practice audit services to meet the needs and expectations of the cluster agencies
- a pool of audit staff and outsourced audit services on behalf of cluster agencies
- integrated information systems incorporating audit technology that will significantly improve the efficiency and effectiveness of audit activities in an environment of growing electronic service delivery.

The table following shows the impacts of different levels of cluster sharing on four key components of internal audit delivery.

**Table 10: Models for Cluster Sharing of Internal Audit**

Option	Model description	Audit & Risk Committee (A&RC)	Cluster-wide audit manager (CAE <sup>a</sup> )	Audit function	Audit support technology
0	<b>No change</b> Separate internal audit governance & function for each agency	One per agency	One CAE per agency	One per agency or shared through outsourcing	One per agency or sharing via outsource audit services
1	<b>Shared A&amp;RC only</b> Common Audit Committee across separate audit functions	One A&RC shared per cluster	One CAE per agency	One per agency or shared through outsourcing	One per agency or sharing via outsource audit services
2	<b>Shared A&amp;RC and CAE only</b> Cluster shared CAE with outsourced audit function	One A&RC shared per cluster	One CAE shared per cluster	One per agency or shared through outsourcing	One per agency or sharing via outsource audit services
3	<b>Lead agency shared cluster services</b> Lead agency in cluster provides shared internal audit services	One A&RC shared per cluster	One CAE shared per cluster	One internal audit function shared per cluster	Shared technology
4	<b>Cluster shared services</b> Common Audit Committee and internal audit function shared across cluster	One A&RC shared per cluster	One CAE shared per cluster	One internal audit function shared per cluster	Shared technology
5	<b>Central control/matrix managed</b> Centralised internal audit management with administrative clusters <sup>b</sup>	One A&RC shared per cluster	One CAE shared per cluster	One internal audit function shared per cluster	Shared technology
Notes:	(a) Chief Audit Executive (b) This is the Canadian Government model				

## 5.15 Key Issues to be Addressed

This section describes the key issues identified by the review, the underlying causes of those issues and how they relate to better practice.

### 1. **There are varying levels of performance across agencies when their internal audit processes are compared with best practice.**

Many organisations could improve compliance with key elements of existing guidance in the *Treasury Statement of Best Practice Internal Control and Internal Audit 1995*.

NSW Government central guidance and support for internal audit is fragmented resulting in organisations relying on their own capability and initiative for developing internal audit practices.

While CEOs are required to have an effective system of internal control, internal audit is not mandated but is to occur 'wherever practicable'.

### 2. **Uneven capacity across the sector in the ability of agencies to use the internal audit functions to mitigate service delivery failure and other business risks.**

Legislation (*Public Finance and Audit Act 1983*) gives the CEO discretion for implementation of internal audit without mandatory minimum policy standards for its governance.

An inter-jurisdictional comparison shows that all other jurisdictions examined by the review have stronger mandatory requirements for internal audit governance compared to New South Wales. Better practice suggests the key to improved internal audit are mandated requirements including: independent Chair and membership of internal Audit Committees; minimum governance requirements e.g. independence from operational management; agreed standards for internal audit practice; independent reporting on compliance to a third party or CEO certification of compliance; and inclusion of risk management in the Audit Committee charter.

Internal audit guidance is being provided from multiple agencies (Treasury, NSW Audit Office, Independent Commissioner Against Corruption and DPC). The NSW Audit Office, Institute of Internal Auditors and private sector firms are more frequent sources of internal audit guidance than Treasury.

Treasury policy (TD 720) and guidance (TPP95a, TPP97) for internal audit generally needs updating. The review identified at least ten guides applicable to NSW agencies with further extensive guidance provided for internal audit professionals. These include Treasury Policy Papers, published professional and industry standards, practice guides and research materials relating to internal audit. There is a need for NSW to consolidate existing guidance which will reduce red tape. Professional and industry standards should be adopted wherever appropriate so that guidance is kept up-to-date in a cost effective manner.

Agencies currently interpret existing policies and standards differently which can result in risks not being adequately identified and addressed. There is a need to apply agreed standards and use common definitions for terms such as corporate governance, risk management and internal control. This will aid better understanding, communication and application of internal audit practices.

The review recommends adoption of a *Better Practice Framework* including common definitions. This will provide the criteria against which compliance can be assessed via the NSW Audit Office's compliance program.

**3. Organisations have varying compliance with accepted best practice for governance of internal audit. The increasing trend in the private sector towards greater independence of Audit & Risk Committee is not yet mirrored across much of the public sector (State Owned Corporations perform better in this regard).**

Strong independent governance is essential to ensure effective internal audit performance. Best practice strongly suggests there should be effective separation between management and the governance of internal audit to ensure independence. However, some CEOs in NSW currently have direct involvement in the oversight of the internal function, including chairing the Audit & Risk Committee. This does not appear to be consistent with public or private sector best practice. Governance is more independent in State Owned Corporations which are encouraged to follow private sector practice.

For the General Government Sector and Public Trading Enterprises, control of internal audit is vested extensively in the CEO who has power for appointment and removal of Audit Committee members and the Chief Audit Executive, making internal audit more vulnerable to management capture.

The review found 36% of Chief Audit Executives report to, or hold the position of, Chief Financial Officer or Corporate Services Executive. Reporting to, or holding the position of, an operational head may compromise audit independence. This does not appear to be consistent with public or private sector best practice.

Responsibility for internal control lies with CEOs under Section 11 (1) of the *Public Finance and Audit Act 1983* who 'shall ensure that there is an effective system of internal control over the financial and related operations of the authority, including:

- management policies and requirements made by the provisions of this Act and the prescribed requirements
- sound practices for the efficient, effective and economical management of functions by each organisational branch or section within the authority
- a system of authorisation and recording and procedures adequate to provide accounting control in relation to assets, liabilities, receipts and expenses
- proper segregation of functional responsibilities
- procedures to review the adequacies of and compliance with the system of internal control.'

Currently internal audit is not mandatory. Section 11 (2) of the *Public Finance and Audit Act 1983* requires 'wherever practicable, the Head of an authority shall establish and maintain an effective internal audit organisation which shall be responsible to the Head of an authority for:

- the regular appraisal of the adequacy of and compliance with the system of internal control
- the review of operations or programs to ascertain whether results are consistent with established objectives and goals and whether the operations or programs are being carried out as planned

- the reporting directly at regular intervals to the Head of the authority as to the result of any appraisal, inspection, investigation, examination or review made by the internal audit organisation.’

The Treasurer, in his October 2005 response to the Public Accounts Committee Report 11/53 *Review of the Operations of Audit Committees*, supported updated advice being issued: reminding agencies of the guidance concerning Audit Committees available on Treasury’s website; explicitly stating that the Chairman of the Board/CEO should not be the Chair of the Audit Committee; and advising that Audit Committee members should be properly inducted and suitably qualified. The draft policy, *Guidelines for Boards of Government Businesses*, currently being finalised by Treasury, includes requirements for Audit & Risk Committee.

State Owned Corporations have stronger internal audit governance arrangements because Audit Committees have direct reporting lines to the Boards who appoint and remove the Chief Audit Executive. Audit committees are usually comprised of independent Board members.

**4. There is no central regulatory mechanism for monitoring and ensuring public sector organisations comply with policy requirements for internal audit.**

The review identified a gap in the regulatory model for internal audit operating in NSW. Guidance is fragmented and widely regarded better practice requirements are not mandated. There is no mechanism for monitoring compliance of public sector organisations with existing internal audit requirements. Compliance monitoring is especially critical for government organisations that operate without an independent Board which is accountable for agency performance.

**5. Many organisations’ risk assessment could be improved to better drive the internal controls as well as priorities for internal audit.**

Where internal audit is conducted in the context of an enterprise risk assessment framework, it is more likely that the most material issues and risks are addressed. Better practice requires:

- resources directed to controls mitigating the greatest risks
- internal audit priorities focused on these risks.

The greatest benefits of internal audit occur when it is risk based and focuses on preventative controls rather than investigative activities. This is particularly the case when addressing the risks of organisational or systems change. For example, proactive internal audit assisted agencies to address issues resulting from changes such as the introduction of new International Accounting standards.

**6. Audit recommendations are often not implemented by management.**

Feedback from some agencies indicated that audit recommendations were often not accepted by management for implementation. There are several issues contributing to this:

- audit findings may relate to and make recommendations on an issue that is immaterial to the organisation achieving its objectives
- accountable management may disagree with the finding or the risk categorisation of the finding

- the solution may have been recommended without adequate consultation with the accountable management who may disagree with the proposed solution
- management may have either decided not to act on the recommendation, or may have assigned such a low priority that it is unlikely to be implemented.

Implementation of agreed internal audit recommendations should rightly be the primary responsibility of management – with internal audit identifying the nature and scope of problem to be resolved; and assisting management develop responses as appropriate.

To achieve this it is vital that internal auditors work in a manner which ensures agreement with agency management on audit findings and recommended solutions – so that 100% of recommendations are always (and must be) implemented in a timely manner.

The solution to any potential disagreement between internal auditors (whether in-sourced or out-sourced) and management is evidence-based control-effectiveness assessments and risk ratings on audit findings, combined with a partnership approach to development of solutions with management. This must provide the basis where all agreed recommendations are implemented.

Chief Audit Executives in public sector organisations indicated problems in ensuring implementation of audit recommendations. Private sector organisations interviewed indicated that this used to be a major problem for them, but they overcame this through strong independent internal audit governance that includes reporting and tracking of the timely implementation of audit action plans. They saw this as critical for obtaining maximum value from internal audit.

Many NSW Government organisations lack a robust system for tracking responsibilities and progress for implementation of internal audit recommendations. The review recommends reporting and tracking implementation of audit action plans by management to the Audit & Risk Committee and the CEO/Board, to ensure all agreed audit recommendations are implemented within the agreed timeframe.

**7. There are opportunities to improve the effectiveness of internal audit functions, particularly for small and medium agencies, by using a cluster approach.**

Large multinational corporations interviewed indicated they used a centralised internal audit model with one central high level Audit & Risk Committee with responsibility across all the countries in which they operated. The Government of Canada also has a centralised model with Chief Audit Executives accountable centrally and a single Audit & Risk Committee covering all small and medium agencies.

Audit technology can be shared where there are common ICT systems servicing clusters of agencies.

There are opportunities to improve the effectiveness for the internal audit function in NSW agencies, particularly for small and medium agencies, by using a cluster approach. This would involve a shared Audit & Risk Committee, a Chief Audit Executive and a single internal audit function. There are various options for sharing of internal audit resources outlined at Table 10 above.

Clusters could be based around State Plan CEO committees or the emerging Shared Corporate Service clusters. The review recommends a pilot cluster approach to internal audit in the first instance.

#### **8. Agencies are often dissatisfied with the results produced by outsourced internal audit services.**

The review surveys indicated a need for an improved approach to the management of outsourced internal audit services. This is necessary to ensure internal audit findings are focused on priority issues and that there is cooperative development of solutions which are agreed with management to address problems identified and to maximise the benefit to the organisation.

Outsourcing internal audit services still requires the agency to have internal audit expertise to manage the engagement to obtain value and benefit from the audit engagements. Outsourcing internal audit can at times result in audit recommendations which are not developed with management and may not lead to strategies that improve the business. Better practice involves internal audit identifying risks (audit findings) for which management then develops solutions and takes responsibility for implementation.

The use of risk assessment of findings is key to determining the importance of issues identified. Audit findings that are immaterial and recommendations that are not feasible were common complaints from agencies using outsourced internal audit services. The better practice private sector organisations interviewed indicated that the application of risk ratings and cooperative development of audit recommendations was critical to addressing this issue.

#### **9. There are no arrangements for exchanging internal audit knowledge and practices across the NSW Public Sector.**

Organisations rely on their own resources and expertise to develop internal audit services and do so working mostly in 'silos'. Responses to the review surveys were strongly supportive of strengthening internal audit networking and knowledge sharing within the NSW Public Sector with central agencies playing a facilitation role.

Private sector interviews and a workshop with the Corruption Prevention Network produced strong advocacy for internal audit and risk management networking and knowledge sharing across the NSW Government. They all indicated the benefits and importance of these forums. They indicated that this kind of arrangement was 'like having one or more extra FTE on your audit staff'.

#### **10. Public and private sectors are concerned about cost effective access to quality personnel and technology resources necessary for providing value from internal audit.**

The private sector recruits young graduates from a range of disciplines with management potential and trains them in internal audit processes before moving them into operational sections of the business. The internal audit experience provides an understanding of the business while ensuring a fresh approach is taken to internal audit and risk management. This approach is preferred to recruiting more expensive career auditors who remain in the function for a long time. However, career audit seniors manage the audit program and engagements.

Technology greatly improves the efficiency and effectiveness of internal audit but limited knowledge of what software to use, and how to use it, restricts access to the technology.

There is a shortage of skills for ICT audit in the public sector.

# 6. Implementation Strategy & Plan

The implementation strategy covers three aspects of internal audit:

## 1. Get the governance right

- stronger central government leadership and regulation for internal audit and enterprise risk management
- all organisations have an Audit Committee that complies with accepted best practice
- monitoring of internal audit activities and outputs and ensuring management accountability for implementing audit recommendations
- facilitating sector-wide knowledge sharing for internal audit professionals and auditors
- capacity in each organisation or cluster to manage/deliver best practice internal audit
- partnership approach between management and internal audit to improve organisational performance

## 2. Get the practices right

- central government sets internal audit requirements based on industry standards and practice guides
- enterprise risk approach used by management drives the control environment and internal audit priorities
- publishing and using audit assessment and rating methodologies for evidence based findings
- internal audit to foster an open culture for improving organisational performance using clear rules of engagement
- providing management with the tools for control self assessment

## 3. Get the resources right

- reducing the cost of internal audit for small/medium agencies by sharing arrangements for resources, technology and Audit Committee oversight
- using technology for preventative, detective and investigative audit activities, audit management and reporting
- having appropriate human resources attraction, retention and training strategies to develop and maintain a quality internal audit function

The implementation plan below flows from this strategy and provides a timeframe for implementation of the approved actions in Section 2.

**Table 11: Implementation Plan**

<b>Implementation Timetable</b>		
<b>Recommendation (Lead Agency)</b>	<b>6 months</b>	<b>12 months</b>
<b>Getting the governance right</b>		
<b>1. Strengthened NSW policy for internal audit and risk management</b> (Treasury/Commerce)	Establish reference group of internal audit experts to update policy and guidance Process for panel of independent members finalised by Commerce by end of March 2008	Treasurer's Direction 720 updated and promulgated by end June 2008 (linked with 4 below) Establish and communicate panel of members to CEOs
<b>2. Internal audit compliance assurance</b> (NSW Audit Office)	Discussions with NSW Audit Office regarding monitoring role and agree key elements to be monitored for compliance	NSW Audit Office commences monitoring internal audit compliance in 2009/10 compliance program (if agreed by NSW Audit Office)
<b>3. Pilot agency cluster with shared internal audit governance and delivery</b> (DPC)	Cluster for pilot agreed. Implementation plan developed in consultation with cluster agencies	Pilot cluster implemented
<b>Getting the practices right</b>		
<b>4. Rationalised, updated and improved better practice guidance for internal audit</b> (Treasury)	Establish reference group for guidance (as in 1 above). Consult with professional associations on practice standards	Updated guidance agreed and promulgated by end June 2008
<b>5. Networks to exchange internal audit and risk management knowledge and expertise</b> (Treasury)	Terms of reference developed in consultation with reference group (as in 1 above)	Networks launched by end June 2008
<b>Getting the resources right</b>		
<b>6. Strategy for access and use of technology in internal audit</b> (Commerce)	BOAC consults with knowledge leaders on internal audit technology and opportunities for sharing	Procurement guidelines agreed and process for implementation and sharing commenced by end June 2008
<b>7. Internal audit human resource development</b> (PSWO, DPC)	PSWO/Treasury to identify suitable forum and strategy to develop internal audit resources and expertise	Strategy finalised for Chief Executives Committee consideration by October 2008
<b>8. Internal Audit Review report published</b> (DPC)	Report promulgated via DPC by end-2007	