



# Auditor-General of Victoria

*Special Report No 6*

## Internal Audit in the Victorian Public Sector

*December 1986*

T. Wood

VICTORIA

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*Report*

of the

*Auditor – General*

**SPECIAL REPORT No 6**

Internal Audit in the Victorian Public Sector

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*Ordered by the Legislative Assembly to be printed*

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1 MACARTHUR STREET  
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The Honourable the Speaker,  
Legislative Assembly,  
Parliament House,  
MELBOURNE. 3000.

November 1986

Sir,

Pursuant to the provisions of Section 48 of the Audit Act 1958, I hereby transmit a report covering a review on internal audit within the Victorian public sector.

The primary purpose of conducting this review was to ascertain the status of the internal audit and to provide constructive suggestions in line with the on-going process of improving financial management and accountability within the sector.

The co-operation and assistance received by staff from the internal auditors and executive heads of departments and public bodies during the course of the review was appreciated.

Yours faithfully,

R.G. HUMPHRY  
Auditor-General

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# REVIEW OF INTERNAL AUDIT IN THE VICTORIAN PUBLIC SECTOR

## 1. EXECUTIVE SUMMARY

### 1.1 Scope of Review

- 1.1.1 HISTORICAL PERSPECTIVE (paras 2.1.1 to 2.1.8): My predecessor commented on the state of internal audit in reports to Parliament between 1977 and 1981. Two parliamentary committees have addressed the issue of internal audit within the public sector of Victoria and have identified the importance of the role to executive management. In 1983, a Bureau of Internal Audit (BIA) was established within the Department of Management and Budget (DMB) to provide leadership and promote consistency and co-ordination of the internal audit function throughout the Victorian Public Service.
- 1.1.2 THE REVIEW (paras 2.2.1 to 2.2.5.): The review evaluated the quality and effectiveness of internal audit within the Victorian public sector focussing on the adequacy of its structure, organisation, staffing, authority and scope. It included an evaluation, where necessary, of internal audit plans and working papers. As part of the review's objectives an assessment was made of the extent of reliance the Office of the Auditor-General could place on the work of internal audit when planning the external audit activities.
- 1.1.3 ROLE AND FUNCTION OF INTERNAL AUDIT (paras 2.3.1 to 2.3.7): Internal audit is an aid to senior management. It provides an independent assessment of financial and management control systems, policies and practices. It reports direct to executive management and therefore provides an early warning mechanism as to the existence of potential problems. It also identifies areas where the efficiency and effectiveness of the organisation can be improved.
- 1.1.4 ORGANISATION AND RESPONSIBILITIES (paras 2.4.1 to 2.4.8): Prior to 1983, responsibility for internal audit in Victoria rested with individual departments and public bodies. The BIA was established in 1983 to provide leadership and promote consistency and co-ordination,

of the internal audit function throughout the Victorian Public Service. However, the initiative for the establishment of an internal audit function within departments and public bodies remains with executive management. At the date of this review many departments and public bodies still had no internal audit function.

## **1.2 Overall Conclusion**

1.2.1 The primary role of internal audit is to assist executive management in ensuring that government and departmental policies and programs are properly implemented.

1.2.2 The effectiveness of internal audit in the public sector in Victoria is dependent to a large extent on attitude, perception and support from executive management. The role seen for internal auditors by the BIA will require highly skilled and motivated staff being attracted to internal audit. Strong commitment is also required from executive management in providing the necessary funding to obtain the resources required. For many years executive management has determined that other programs should receive greater priority and therefore funds have been directed to areas where an immediate impact can be achieved. This approach may provide short-term benefits but not necessarily in the longer term, as the savings to an organisation through an effective internal audit function are of considerable magnitude.

1.2.3 At present there is a general lack of resources and executive support for internal audit in many organisations. This is particularly important in the case of the BIA which has the responsibility of co-ordinating the internal audit function.

### 1.3 Summary of Audit Observations and Recommendations

#### MANAGEMENT'S PERCEPTION OF INTERNAL AUDIT ROLE (paras 3.1.1 to 3.1.14)

1.3.1 In most organisations with internal audit units staffed from within the organisation, executive management had a sound knowledge of the role of internal audit and the manner in which it could provide valuable assistance to management.

1.3.2 On the other hand executive management of organisations employing private practitioners as internal auditors did not in most instances understand the benefits to be derived from an effective internal audit unit nor did they appreciate the differences between the role and responsibilities of external and internal audit. As a consequence these managers were under the misapprehension that the audit activities were being duplicated and therefore were not cost effective.

1.3.3 Generally, executive management has not perceived the opportunities which are available to their organisations through ensuring that their internal audit unit has the breadth of vision and expertise to make valuable contributions to the efficiency and effectiveness of the organisation in a constantly changing environment.

1.3.4 Audit recommends that:

- . executive management give high priority to the establishment of a dynamic internal audit unit which is capable of contributing to the corporate objectives of the organisation and ensuring that government and departmental policies are properly implemented
- . executive management ensure that the services provided by private practitioners are compatible with those expected of an internal audit function
- . annual meetings be held between external audit, internal audit and executive management to facilitate the achievement of a cost effective audit



- . executive management establish performance indicators to enable an assessment of the cost effectiveness of the internal audit unit to the organisation
- . the BIA implements appropriate education programs to ensure executive management appreciates the benefits of having a vibrant internal audit unit and understands the role and policies of the BIA.

STAFFING OF INTERNAL AUDIT (paras 3.2.1 to 3.2.22)

- 1.3.5 Generally internal audit, other than in some major public bodies such as the State Electricity Commission and the Totalizator Agency Board, has a low profile within the Victorian public sector. The review noted that certain large organisations controlling substantial public funds have still not established an internal audit function.
- 1.3.6 Unfortunately, given the competing demands on management to achieve government objectives, a higher priority has been given to other programs and initiatives at the expense of adequately resourcing or establishing an effective internal audit capacity for the organisation. A similar situation of under-resourcing exists within the BIA and consequently has restricted the progress it has made in upgrading the status of internal audit within the Victorian Public Service.
- 1.3.7 It was pleasing to note that 88 per cent of internal audit staff possessed appropriate tertiary qualifications which extended in many instances beyond accounting to other disciplines. There were however substantial deficiencies in EDP skills and expertise. As a consequence, management is at risk because many internal audit units cannot provide sufficient assurances on the integrity of data maintained on computerised systems.
- 1.3.8 Audit recommends that:
- . large organisations with no internal audit unit give high priority to the early establishment of a viable unit
  - . organisations unable to support an economically viable internal audit unit be serviced by the BIA

- . the PSB in conjunction with DMB give recognition to internal audit as being an essential aid to executive management by ensuring that an adequate establishment, career path and salary structure is available throughout the public sector
- . high priority be given to adequately resourcing the BIA
- . executive management review their internal audit establishment periodically to ensure the unit has adequate staff with appropriate skills
- . the BIA expand existing training programs for internal auditors to ensure that audit skills of internal audit staff are maintained at a professional level.

SCOPE AND COVERAGE OF INTERNAL AUDIT (paras 3.4.1 to 3.4.16)

- 1.3.9 Generally speaking system-based methodology has been utilised by the profession as established practice for many years. This approach recognises the continuing growth in the volume of financial transactions within organisations. It was therefore of some surprise to note the high incidence of the use of transaction-based methodology by private practitioners as transaction oriented audit techniques are generally less cost effective.
- 1.3.10 Having regard to the potential audit risks which may emanate from computerised systems the time apportioned by internal auditors to the audit of EDP systems was considered to be inadequate. This lack of involvement in EDP auditing was, to some extent, compounded by difficulties encountered in recruiting and retaining staff with EDP skills and expertise.
- 1.3.11 Audit recommends that:
- . the systems-based methodology be adopted by all internal auditors including contracted private practitioners
  - . the purchase and/or development of computer assisted audit techniques (CAATS) to assist internal auditors

- . in conjunction with the BIA, executive management should continue to seek audit personnel with appropriate EDP skills and expertise to enable effective audit coverage of computerised systems.

#### AUDIT PLANNING (paras 3.5.1 to 3.5.8)

- 1.3.12 Whilst planning was recognised as being essential by all internal audit units, nevertheless it was evident that in many instances inadequate attention had been given to the planning process. Management cannot expect internal audit to be effective until proper annual and strategic plans covering all areas and activities of the organisation have been prepared and approved by the executive head, the board or the audit committee.
- 1.3.13 Where private practitioners are employed as internal auditors, the audit plans were developed prior to the commencement of the audit but generally speaking, those plans were neither considered nor approved by the executive head despite the fact that a cost was incurred by the organisation for such services.
- 1.3.14 Audit recommends that:
- . annual and strategic audit plans be prepared, taking into account all areas to be examined, having regard to audit risk and materiality
  - . executive management, the audit committee or board approve the plans prior to the commencement of the audit year
  - . communication during the planning process between internal audit and external audit be improved to ensure a co-ordinated approach to the auditing activities for the year.

PROCEDURAL MANUAL (paras 3.5.9 to 3.5.11)

- 1.3.15 The review noted that 59 per cent of the organisations with an internal audit unit had not developed an audit manual. Priority should be given to the development of an audit manual for use in the Victorian public sector. This manual should incorporate audit standards and practice, audit methodology, EDP auditing, planning procedures etc. The head of the BIA advised that an internal audit procedural manual is currently being developed by a working party under the BIA's direction.

PERFORMANCE OF INDIVIDUAL ACTIVITIES (paras 3.5.16 to 3.5.24)

- 1.3.16 It was pleasing to note most internal audit units had developed adequate audit plans in advance of conducting specific activities. However the coverage given to a specific activity was limited to a set period rather than covering a complete year and as a consequence the Office of the Auditor-General could not, in many instances, rely on work performed by the internal audit units staffed from within an organisation for the purpose of the attestation of annual financial statements. Notwithstanding this deficiency the quality of work performed on specific systems and activities was generally considered to be satisfactory.
- 1.3.17 Where private practitioners were employed as internal auditors, their audit work was usually complementary with that of the Office of the Auditor-General and therefore resulted in cost savings to particular organisations.
- 1.3.18 Whilst approximately 70 per cent of audit recommendations were acted upon by management, the review found that corrective action taken by management, on such recommendations was not monitored in a timely manner by 88 per cent of internal audit units staffed from within the organisations. On the other hand only 5 per cent of private practitioners did not monitor corrective measures taken by management.

1.3.19 Audit recommends that:

- corrective action taken by organisations on recommendations made by internal audit on specific activities be regularly monitored to ensure that the relevant systems and management controls are operating satisfactorily and any anticipated savings identified in the audit recommendation are achieved
- the internal audit coverage of financial and accounting systems be extended to include the complete year so as to complement the work of the external auditor. Such coverage by the internal auditor would also provide an assurance to the executive head on the integrity of the financial statements.

MANAGEMENT OF INTERNAL AUDIT (paras 3.6.1 to 3.6.4)

1.3.20 Only 37 per cent of organisations with internal audit units staffed from within the organisation had established management information systems to record and monitor the allocation of resources to internal audit activities. In many instances budgets were not established for audit activities and actual times were not recorded. Without such information the resources available to the unit cannot be effectively utilised and controlled. Whilst proper supervision of audit work occurred during the conduct of the activity, 75 per cent of units had not established an appropriate quality assurance program to ensure all audit activities were supported by appropriate audit evidence and conducted in accordance with internal audit standards.

1.3.21 Audit recommends that:

- an appropriate management information system be established incorporating budgets and actual times on each audit activity contained in the approved plan
- a quality assurance program be developed by each internal audit unit to ensure all audits are supported by appropriate evidence and that audits have been conducted in accordance with audit standards.

CENTRAL AGENCY SUPPORT (paras 3.7.1 to 3.7.8)

1.3.22 The review found that the BIA was not known by executive heads of the majority of organisations within the Victorian public sector and only 41 per cent were aware of any contact or communication with the BIA. The head of the BIA advised that its operations to date had been confined to the inner budget sector. In addition the BIA has not yet been adequately resourced and therefore it has not effectively achieved its objectives. In recent times some positive output has occurred with the conduct of professional development courses, periodical seminars and secondment of departmental officers to the BIA.

1.3.23 The advice offered by the Public Service Board (PSB) since July 1983 for improving internal audit in the public sector has been minimal and only 9 per cent of executive heads indicated they had received assistance.

1.3.24 Audit recommends that:

- . the BIA ensure it provides access to its services and expertise to all public sector organisations and that the head of the BIA promote the image of internal audit with executive management
- . the BIA broaden its role to cater for user needs as well as giving high priority to providing the necessary advice and expertise in areas identified by particular units such as EDP, procedure manuals, promotion of image, role of internal auditors and professional development.

AUDIT COMMITTEES (paras 3.8.1 to 3.8.4)

1.3.25 Few organisations have established audit committees and most executive heads are not familiar with their role or the benefits that can be gained from the establishment of an audit committee having expert representation from outside the organisation. Audit recommends that major departments and public bodies establish audit committees.

## **2. SCOPE OF REVIEW**

### **2.1 Historical Perspective**

- 2.1.1 Between 1977 and 1981, my predecessor expressed concern in several reports to Parliament at the inadequate state of internal audit in most government departments and public bodies in Victoria.
- 2.1.2 It was pointed out in those reports that internal audit provides an invaluable aid to executive management in the review and control of departmental activities and it was recommended that steps be taken to extend its use throughout all departments and the larger public bodies. The view was also expressed that an effective internal audit activity is an essential feature of efficient management. It is one of the most effective means available to an organisation to ensure that proper control procedures are in operation.
- 2.1.3 While the roles of internal and external audit are completely different in that the objective and responsibility of the external auditor (Auditor-General) are to report independently to Parliament whereas the internal auditor serves and is responsible to the management of the organisation, the audit scope and coverage are often similar. Scarce auditing resources can be conserved if internal and external audits complement rather than duplicate one another. As such the external auditor is able to place reliance on internal audit work provided such work is carried out in an independent and professional manner. As a consequence co-ordination of the internal and external audits can result in a more cost-effective audit for the organisation.
- 2.1.4 In 1981 the Public Bodies Review Committee published a consultant's report on a study of the audit and reporting responsibilities of public bodies in Victoria. In that report internal audit was reviewed in some depth and a proposed statement of responsibilities of internal auditors was outlined.

2.1.5 The Parliamentary Economic and Budget Review Committee in its 1983 Report, Improving Government Management and Accountability, also addressed the issue of internal audit. It identified the importance of internal audit to senior management and in general terms expressed concern at the lack of priority given by government managers to the development of an adequate internal audit function. The Committee recommended in its report that new legislation should specify the development and maintenance of an adequate internal audit function as a management responsibility and that a program be instituted by DMB and PSB to urgently upgrade the internal audit function throughout the Victorian public sector.

2.1.6 Whilst no specific legislation covering internal audit has been promulgated following the Committee's 1983 report, in recent times new legislation in relation to particular organisations has included provisions requiring such organisations to establish an internal audit function. Also the BIA was established in 1983 within DMB under the department's stated role of improving the quality of financial management within government organisations. At the same time the PSB issued a discussion paper to clarify and strengthen the role of internal audit in the Victorian Public Service. The policy issues relative to internal audit raised in the paper were discussed at a public meeting in July 1983.

2.1.7 In 1984 the BIA issued draft standards for internal audit within the Victorian Public Service. It has conducted training programs for internal auditors and other interested parties and has implemented a secondment program to the BIA for departmental officers interested in internal audit.

#### Subsequent Developments

2.1.8 Subsequent to the completion of this review, DMB forwarded a discussion paper on the development of internal audit functions in government departments and agencies to all executive heads on 7 October 1986. The paper proposes the preferred role of internal audit in the Victorian Public Service and follows the outcome of discussions with Chief Administrators and surveys of internal audit operations by the BIA. The preferred role centres around programs and



places emphasis on the efficiency, economy and effectiveness of the internal management practices and controls. DMB has sought comment on the discussion paper from departments in relation to the proposals for the preferred role of internal audit and also to the assessments of internal audit needs. The BIA has indicated that an internal audit procedural manual is being prepared by a working party comprising public sector internal auditors under the direction of DMB.

## 2.2 The Review

2.2.1 PURPOSE: The purpose of the review was to evaluate the quality and effectiveness of internal audit in government departments and public bodies in Victoria, focussing on the adequacy of its structure, organisation, staffing, authority and scope and including an examination, where necessary, of internal audit plans and working papers.

2.2.2 SCOPE AND APPROACH: The review was undertaken during 1985 and 1986 and covered 71 selected organisations as listed in Appendix 1 of this report. These organisations consisted of all departments including certain branches and a selection of public bodies. Details are summarised hereunder:

	With Internal Audit	Without Internal Audit
Departments, branches etc.	11	13
Public bodies	42	5

2.2.3 The review consisted of two separate phases. The first phase embraced the development and issue of a questionnaire to the selected organisations with an internal audit unit. It addressed the adequacy of:

- (1) staffing within the internal audit unit;
- (2) status of the internal audit unit;

- (3) scope and coverage of internal audit;
- (4) planning, execution and reporting of internal audit projects and programs; and
- (5) support given to the internal audit unit by DMB and PSB.

2.2.4 Responses to this questionnaire were obtained from each organisation with an internal audit unit irrespective of whether the unit was staffed from within the organisation or engaged private practitioners to provide the function. However, the questionnaire completed by the private practitioners did not include the section on the adequacy of staffing as it was considered inappropriate to review this aspect of private practitioner's operations.

2.2.5 In the second phase, the Chief Directors of Audit visited all selected organisations and sought the views of the executive heads to the following:

(1) Where an internal audit unit existed

- . their understanding of the role of internal audit, the main contributions which internal audit is able to make to the organisation and whether value for money is being obtained from the operations of their internal audit
- . their understanding of the role of an audit committee and whether such a committee has been considered and/or established within the organisation
- . their knowledge of the existence and role of the BIA

In instances where private practitioners provide the internal audit function for a public body, the executive heads of the organisations were also questioned on their understanding of the different roles of internal and external audit.

(2) Where an internal audit unit did not exist

- . the level of priority given by the organisation to the establishment of an internal audit unit
- . their knowledge of the existence and role of the BIA

**2.3 The Role and Function of Internal Auditing**

2.3.1 Internal auditing is defined by the Institute of Internal Auditors as:

"..... an independent appraisal activity established within an organisation as a service to the organisation. It is a control which functions by examining and evaluating the adequacy and effectiveness of other controls."

2.3.2 In establishing interim standards for internal audit within the Victorian Public Service in January 1984, DMB adopted and expanded the Institute's definition of internal auditing as follows:

"..... an independent appraisal function within an organisation for the review of activities as a service to the organisation. It is a managerial control which functions by appraising and reporting on the effectiveness of other controls.

The objective of internal auditing is to assist members of the organisation in the effective discharge of their responsibilities. To this end internal auditing furnishes them with analyses, appraisals, recommendations and information concerning the activities reviewed.

Internal audit is a staff function as distinct from a line function and the head of the internal audit unit and his staff must have no responsibility for or authority over the activities they audit."

2.3.3 The interim standards on internal audit in the Victorian Public Service extend the scope of internal audit, previously limited to accounting and financial operations, to encompass all operations of an organisation. The interim standards indicate that the scope should include:

- (1) a review of the reliability and integrity of the financial and operating information and the means used to identify, measure, classify and report such information;
- (2) a review to determine the adequacy of the systems established to confirm compliance and the degree of compliance with those policies, procedures, laws and regulations which have a significant impact on operations and reports;
- (3) a review of the means of safeguarding assets and of verification of the existence of such assets;
- (4) an appraisal of the economy and efficiency with which resources are employed or of the adequacy of measures adopted by management to assess such economy and efficiency; and
- (5) an appraisal of the effectiveness of operations or programs or the adequacy of measures adopted by management to assess such effectiveness.

2.3.4 Internal audit assists management by independently assessing and reporting upon financial and management controls, policies, practices and systems. It can be senior management's early warning system alerting it to existing and potential problems and identifying the areas in which improvement can be made. (British Columbia Review of Internal Audit)

2.3.5 Internal auditing should identify weaknesses in established procedures needing management's attention to ensure compliance with those procedures. It should also evaluate the design of accounting and control systems and recommend improvements and provide guidance, advice and technical assistance to those officers being reviewed.

2.3.6 The internal auditor's function, however, does not in any way relieve or negate operating managers and executives of their responsibilities. It is management's responsibility to evaluate programs and operations; it is the internal auditor's responsibility to provide independent oversight.

2.3.7 To be comprehensive and effective, the internal auditing function should:

- . contribute to the effective achievement of the corporate objectives of the organisation
- . provide senior management with a continuing, independent appraisal of all aspects of the organisation's activities
- . have an organisational status that will permit it to report objectively on any operation or activity of the organisation
- . be independent so as to render impartial and unbiased judgements on organisational activities
- . be clearly communicated to all staff in a mandate from the executive head of the organisation
- . have sufficient professionally competent staff and other resources to carry out its responsibilities
- . ensure through good audit planning that all activities are identified, ranked in order of priority and the appropriate audit objectives determined for each activity selected for audit
- . define appropriate standards of performance and apply them in each audit assignment
- . document the results of the audit in a formal report to provide a constructive vehicle for change, discuss it with the managers affected and present the report on a timely basis to the executive head of the organisation and, where appropriate, to the audit committee

- . have the leadership and support of executive management and/or an audit committee composed of executive management and qualified persons from outside the organisation to provide additional objectivity.

## **2.4 Organisation and Responsibilities**

- 2.4.1 Prior to 1983, the responsibility for the establishment and operation of the internal audit function rested with individual departments and public bodies. Its successful implementation into an organisation was dependent to a large extent on the perceived views on internal audit by executive management of that organisation.
- 2.4.2 There were no underlying guidelines from the central agencies to assist and encourage executive management in the development of the internal audit function within an organisation. Other than individual instances where executive management was fully supportive and receptive, there was no impetus or direction for improvement in the function within the public sector.
- 2.4.3 In 1983, the Parliamentary Economic and Budget Review Committee in its report, *Improving Government Management and Accountability*, addressed the issue of internal audit and identified its importance to executive management of an organisation. In general terms, the Committee expressed concern at the lack of priority given by managers to internal audit and recommended that new legislation specify the development and maintenance of internal audit as a management responsibility. DMB and the PSB were encouraged to institute a program to urgently upgrade the internal audit function throughout the public sector.
- 2.4.4 Subsequent to the report, the PSB issued a policy paper for discussion amongst interested parties on the role and staffing of internal audit. Following the discussion of the paper at a public hearing of the PSB, a review committee was set up to examine a number of important issues requiring resolution before a revised internal audit role statement could be finalised.

2.4.5 At the same time, DMB, which has the responsibility for improved financial management throughout the public sector, established the BIA to provide leadership and promote consistency and co-ordination of the internal audit function throughout the Victorian Public Service. The BIA's charter empowers it to:

- (1) perform internal audits within DMB;
- (2) set and issue policies and standards on internal audit; and
- (3) provide advice, assistance and audit services to other departments and agencies within the public sector.

2.4.6 The contents of the original policy statement were subsequently included in interim standards for internal audit issued by DMB in January 1984, the purpose of which, as stated by the Treasurer when releasing the statement, was:

"to aid departments in establishing or reorganising internal audit functions and conducting audits with the aim of providing effective internal audit coverage over all properties, records, functions, operations and programs."

2.4.7 These interim standards have application to all internal audit work undertaken in departments and include such matters as:

- the role of internal audit
- the scope of the internal audit function which should cover all activities and related management controls having regard to the adequacy of internal controls, materiality and available resources
- the effectiveness of internal audit being dependent substantially on its degree of independence
- the management and staffing characteristics of the internal audit function

- . the essential elements relative to the performance of the audit.

2.4.8 The BIA anticipated further development of the standards through the continuing experience of departmental units and through developments and refinements in professional internal audit practices. The Treasurer indicated that a final draft of internal audit standards would be submitted for the approval of the Governor-in-Council when provision is made in the appropriate legislation on resource management and accountability.



### **3. AUDIT OBSERVATIONS AND RECOMMENDATIONS**

#### **3.1 Management's Perception of the Role of Internal Audit**

- 3.1.1 An important pre-requisite for the effective operation of an internal audit function is an appropriate understanding of its role, responsibilities and potential for executive management. Management must understand the way in which internal audit can assist it in carrying out its responsibilities in ensuring that government and departmental policies are properly implemented. Internal audit should contribute to the corporate objectives of the organisation and should justify its existence through its contribution to the effective achievement of those objectives. In many respects the quality of internal audit reflects the quality of executive management of the organisation. Good management ensures it receives the optimum value from internal audit as it readily recognises the importance of the role of internal audit to effective management. Its success depends more than any other factor on the actual and visible support of executive management and senior personnel. Active support from management within an organisation will ensure that appropriate resources are provided to internal audit, that it has a high profile within the organisation and that it gains the respect of senior managers.
- 3.1.2 The existence of good management systems and practices should contribute to the reduction of auditing costs as auditors only carry out sufficient work to support their conclusions. If management has unsatisfactory or unreliable systems in place then it follows that the auditor will need to extend the testing to enable an opinion to be reached. Likewise if executive management does not ensure that internal audit work is complementary to external audit, then additional work will be required with consequent increases in audit fees.
- 3.1.3 The review indicated that in most organisations which have an internal audit function staffed from within the organisation, there is a good understanding by executive management of the role of internal audit and the way it can assist management.

3.1.4 Executive management considers that internal audit has the capacity to make a vital contribution to the organisation through the provision of assurances to management on the operations of the various systems and on the extent to which such systems are achieving organisational objectives. They also believe that internal audit has an important role to play in ensuring compliance with legislation and organisational policy. Executive management expects internal audit to identify potential problems and to provide constructive suggestions for corrective action. In practice executive management was not always achieving the expected benefits from its internal audit unit although, in 75 per cent of the organisations with internal audit units staffed from within the organisation, the executive heads considered they were getting value for money from the work of their internal auditor. However, in no organisation other than the Totalizator Agency Board were performance indicators in place to assess the cost effectiveness of the unit and to ensure that value for money was being obtained from the work output of the unit. Likewise, executive heads of organisations employing private practitioners to undertake the internal audit function indicated that they were obtaining value for money from the provision of these services yet no performance indicators other than at the Rural Finance Commission were in place to substantiate this opinion.

3.1.5 However, it is disturbing to report that executive management of approximately 50 per cent of the organisations with an internal audit function provided by private practitioners generally had little or no appreciation or understanding of the role. Many executive heads considered that the private practitioners were in fact the external auditor of the organisation despite the fact that the private practitioner was appointed by the organisation to perform the internal audit function. They considered that the audit performed by the Auditor-General, in accordance with the statutory requirements, was therefore a duplication of that performed by the private practitioners. There was little appreciation by those executive heads of the parliamentary requirement for an independent appraisal by the Auditor-General thereby providing credibility to the financial information tabled by the organisation in Parliament.

3.1.6 The BIA is responsible for the improvement and development of internal audit within the Victorian Public Service. To ensure the effectiveness of the BIA there is a need for it to actively communicate its policies throughout the whole public sector. The audit review undertaken during 1985 and 1986 sought to ascertain the extent to which the BIA had communicated information on its role and responsibilities to executive heads. The following table outlines executive head awareness of the BIA.

Organisation	Total	Aware of BIA	Unaware of BIA
With internal unit staffed from within the organisation	32	16	16
Private practitioner performing internal audit role	21	1	20
No internal audit unit	18	7	11
	71	24	47

3.1.7 The review indicated that the level of active interest by executive management in the operations of the internal audit unit varied significantly between individual organisations. In some cases the executive head of the organisation was closely involved in the formulation of the internal audit program and in the review of its findings. In others the executive head followed an exception approach of only dealing with internal audit reports where there was disagreement amongst divisional management concerning the recommendations made in internal audit reports or if it was not proposed to implement certain of the internal audit recommendations.

- 3.1.8 In some cases the view was expressed that it is not appropriate for internal audit to carry out an attest or financial audit role as this is the responsibility of the Auditor-General. Despite this view management considered that the internal auditor should evaluate financial systems but be precluded from involvement in the attestation of financial statements.
- 3.1.9 An attest or financial audit involves the evaluation and testing of the financial and accounting systems and consideration of the presentation of the information produced by the system in terms of whether such information is presented fairly in the financial statements. Given internal audit involvement in reviewing certain operations of the financial and accounting systems, it follows that a substantial part of the attest audit work is already undertaken by internal audit. If such work is properly carried out the external auditor is able to reduce the amount of testing necessary due to the reliance that can be placed on the work of the internal auditor. It therefore follows that the involvement of the internal auditor in the attest audit leads to the achievement of a more cost effective audit for the organisation.
- 3.1.10 Executive heads of organisations are required to certify their financial statements and it would be appropriate for an assurance to be sought from within the organisation before such certification. Obviously, the internal auditor is best placed to provide this assurance.
- 3.1.11 In the 23 organisations employing private practitioners as internal auditors covered by the review 87 per cent provided in their engagement contract solely for the attest audit whereas in the 32 organisations staffing their internal audit unit from within the organisation only one devoted its entire time to the attest audit. The review noted that 12 of these latter organisations devoted less than 40 per cent of available time to the attest audit.
- 3.1.12 Further, there was a failure by executive heads to fully appreciate the distinction between the role of internal audit and that of a management advisory or consultancy unit within the organisation. In order to preserve the objectivity and independence of the internal

audit unit, it is essential that the unit not be involved in any detailed design or implementation of systems and procedures which the unit will subsequently be required to evaluate. Some executive heads consider that internal audit involvement, in such matters as design and implementation, was the only way it could be directly useful to management. The review noted that the internal auditors of 3 organisations were involved in operating responsibilities and consequently their independence was impaired.

### Recommendations

#### 3.1.13 Audit recommends that:

- (1) executive management give high priority to the establishment of a dynamic internal audit function which contributes to the achievement of the corporate objectives of the organisation and ensures that government and departmental policies are being properly implemented;
- (2) to ensure a more effective audit is achieved:
  - (i) a meeting be held between external audit, internal audit and the executive head of each organisation prior to the commencement of the annual audit. This meeting would provide a forum to discuss such matters as key issues affecting the organisation, the organisation's timetable for the preparation and presentation of financial statements, planned audit coverage for the year, estimated audit fee etc.; and
  - (ii) the internal audit coverage of financial and accounting systems be extended to include the complete year so that an assurance on the integrity of the financial statements can be provided to the executive head of the organisation prior to the adoption of the financial statements at year end. The extended coverage would eliminate any existing duplication of effort between internal and external audit on the attest audit of the financial statements;

- (3) performance indicators be established by executive heads to enable assessments to be made of the cost effectiveness of the internal audit unit and to ensure that value for money is being obtained from the work output of the unit;
- (4) when engaging private practitioners to perform the internal audit function, the organisation should ensure that the services provided by the private practitioner are compatible with those of an internal audit function;
- (5) the BIA ensure that its role and policies are understood by all Chief Administrators and general managers who should provide the necessary support to the development of an effective internal audit function within their own organisation;
- (6) an education program be developed and provided by the BIA to executive management outlining the benefits that can be derived from a dynamic internal audit, its usefulness from a management viewpoint and the contribution it can make to the corporate objectives of the organisation; and
- (7) the independence of the internal auditor be safeguarded by not being directed to participate in operating responsibilities such as the implementation of new systems.

3.1.14 It is pleasing to note that in the discussions between the Chief Directors of Audit and executive heads of organisations, all with the exception of one Chief Administrator agreed to participate in pre-audit meetings. In many cases such meetings took place prior to the commencement of the 1985-86 audit.

## **3.2 Staffing of Internal Audit**

### NUMBER OF INTERNAL AUDIT STAFF

3.2.1 From the responses received from the organisations included in the review, 188 internal audit staff were employed in the Victorian public sector out of an approved total establishment of 228. In addition, a number of the public bodies employed private practitioners to provide

various internal audit services which in some instances are referred to as a continuous auditing function. Certain legislation such as that governing the operations of Colleges of Advanced Education and Technical and Further Education Colleges provides for the employment of continuous auditors and invariably private practitioners are used for this purpose. The following table compares the number of internal audit staff, excluding private practitioners, employed by public sector organisations in 1981 and 1985:

	Establishment			Actual		
	1981	1985	Increase %	1981	1985	Increase %
Departments, branches etc.	43	62	44	31	45	45
Public bodies	112	166	48	118	143	21
Total	155	228	47	149	188	26

3.2.2 Of the 45 internal audit staff employed within departments 19 (42 per cent) are located within the Ministry of Education and are mainly involved in the audit of the books and accounts of high schools and technical schools.

3.2.3 Within the public bodies employing their own internal audit staff 92 (64 per cent) of the total of 143 are located within the following 6 major organisations:

<u>Organisation</u>	<u>Establishment</u>	<u>Actual</u>
State Electricity Commission	28	26
State Transport Authority	23	17
Melbourne and Metropolitan Board of Works	18	16
Gas and Fuel Corporation	14	14
Metropolitan Transit Authority	11	10
Totalizator Agency Board	<u>14</u>	<u>9</u>
	108	92
	—	—

- 3.2.4 The executive heads of 56 per cent of organisations reviewed considered their internal audit establishment was satisfactory whilst 38 per cent considered it was not. A further 6 per cent indicated it was too early to assess following recent up-grading of the function. However, 19 per cent of the organisations indicated that no formal review of the internal audit establishment had occurred since 1982 or earlier and in one instance no review had ever been undertaken.
- 3.2.5 It is not possible to determine exactly what the required number of internal auditors is for an adequate internal audit function in the Victorian public sector. In any case to make such an assessment is beyond the scope of this review which does not seek to suggest what specific staff numbers might be required for internal audit in each organisation. Such an assessment can only be made by examining in detail the requirements of individual organisation's units and even then the desired number of internal auditors is dependent on management's determination of the extent of the scope for its internal audit function. Suffice to say, a good internal audit unit would have sufficient staff to conduct investigations of all auditable areas of an organisation within a planned cycle. As indicated earlier, this review did not seek to identify specific staff numbers required nevertheless it can be clearly stated that internal audit staff numbers in particular organisations are inadequate.
- 3.2.6 Audit noted that certain large organisations have no internal audit function. These included the Ministry for Police and Emergency Services, the Ministry for the Arts, the Department of Labour, the Department of Industry, Technology and Resources, the Victorian Government Printing Office and the Victorian Prison Industries Commission. All these organisations have substantial resources available to them and significant areas of audit risk which should be subject to frequent internal audit coverage.
- 3.2.7 Subsequent to the review the Legal Aid Commission, the Office of Corrections and the Department of Property and Services have taken action to establish internal audit units. The Ministry of Planning and Environment is establishing an internal review group and the State Superannuation Board has upgraded its unit.



- 3.2.8 A number of smaller organisations such as the Urban Land Authority, the Department of Premier and Cabinet, the Local Government Department and the Ethnic Affairs Commission were not considered to be of sufficient size by their executive head to maintain a viable internal audit unit.
- 3.2.9 Other organisations with significant areas of audit risk have very small internal audit units. The unit is therefore unable to provide an adequate coverage of all the auditable areas of the organisation. DMB is one such organisation and major deficiencies exist in the audit coverage provided by that unit, for example, there is no adequate internal audit coverage of the preparation of the Treasurer's Statement or the central accounts of government. Likewise in the major revenue raising branches of DMB such as the Land Tax Office and the Stamp Duties Office the internal audit coverage was minimal. Any major weaknesses in systems or procedures within either of these Offices could result in substantial losses of revenue.
- 3.2.10 Apart from DMB the review identified another 7 organisations where the internal audit coverage was considered inadequate due to the understaffing of the unit within the organisation. These organisations were the Department of Agriculture and Rural Affairs (1 officer), the Law Department (3), the State Superannuation Board (2), the Department of Conservation, Forests and Lands (3), the Grain Elevators Board (1), the Department of Community Services (2) and the Rural Water Commission (1).
- 3.2.11 Very small internal audit units (2 persons or less) are not generally regarded as viable. The Commonwealth review of internal audit suggested a minimum size of 4 staff. Organisations not requiring a unit of that size could be serviced by a central bureau such as the BIA or engage private practitioners to provide the function.
- 3.2.12 The review identified a number of departments which have requested funding for increases in staffing numbers to provide an internal audit function or to expand the existing unit but these requests have not been agreed to. Over recent years requests by executive heads of the Department of Agriculture and Rural Affairs, the Ministry for the

Arts, the Department of Water Resources, the Local Government Department and the Ministry of Consumer Affairs have been rejected by the PSB. The failure of these departments to pursue the establishment of an adequate internal audit function reflects the level of priority each organisation has given to internal audit compared with other areas of the organisation's activities.

#### ADEQUACY OF QUALIFICATIONS, TRAINING AND PROFESSIONAL DEVELOPMENT

- 3.2.13 It is important that internal audit staff be properly qualified professionally and receive adequate training and continuing professional development throughout their careers. As a minimum an appropriate tertiary qualification and/or membership of a professional organisation should be held by all internal audit staff in view of the professional and analytical nature of the work. Qualifications of internal audit staff need not only be accounting based as the scope of the internal audit function should embrace all activities of the organisation.
- 3.2.14 It is pleasing to note that 166 officers (88 per cent) of the total internal audit staff held appropriate tertiary or professional qualifications.
- 3.2.15 In all but a few organisations internal audit staff are encouraged to maintain continuing professional development by attendance at outside courses and conferences.
- 3.2.16 However, in a significant number of instances (41 per cent), organisations were unable to provide adequate internal professional training for staff to maintain and develop internal audit skills. To some extent this is a reflection of the small size of some of the internal audit units. Some larger organisations such as the State Electricity Commission and the transport bodies have devised relatively comprehensive internal audit training programs. A number of organisations commented on the desirability of a service-wide approach to training being developed. As indicated previously, this should be a specific function of the BIA. The BIA has recently carried out some successful training programs, although it is clear much more remains to be done in this area.

## ADEQUATE TECHNICAL SUPPORT

- 3.2.17 Eight organisations (25 per cent) identified inadequacies in the technical support available for specialised internal audit reviews. The major deficiencies related to EDP expertise to enable the effective audit of computer based systems. This reflects the general shortage of EDP auditors throughout the auditing profession.

## ABILITY TO RECRUIT AND RETAIN STAFF

- 3.2.18 Sixteen organisations (50 per cent) identified problems in the recruitment and retention of internal audit staff. Some of the reasons for the problems stated by these organisations were:

- . salary rates for many internal audit positions do not compare favourably with market rates particularly in relation to EDP auditors
- . internal auditing is not regarded as an attractive career choice and it is very difficult to ensure a career path in internal audit within an organisation or even within the public sector.

- 3.2.19 Only 11 positions of internal audit head were graded as the equivalent of the senior executive service of the Victorian Public Service and 9 of these positions were located in public bodies.

- 3.2.20 Public bodies have a greater appreciation of the need for adequate grading and status of internal auditors compared with government departments where grading is significantly lower.

- 3.2.21 Difficulties in retaining staff in internal audit generally result from the lack of an audit career path within the organisation. This causes well qualified staff to move into operational positions such as finance or in some instances to internal audit positions in the private sector. There is an urgent need to create an adequate career path in internal audit in the public sector and this would require the general upgrading of internal audit positions, the creation of a greater number of positions and improvements for mobility of internal auditors between organisations.

## Recommendations

### 3.2.22 Audit recommends that:

- (1) executive heads review their internal audit establishment periodically to ensure the unit has adequate staff with appropriate skills including EDP so as to provide executive management with an assurance that the organisational objectives are being met;
- (2) large organisations with no internal audit unit give high priority to the early establishment of a viable unit;
- (3) the BIA expand existing training programs for internal auditors to ensure that the audit skills of internal audit staff throughout the public sector are maintained at a professional level;
- (4) the BIA actively encourage the formation of discussion groups for the benefit of public sector internal auditors;
- (5) high priority be given to adequately resourcing the BIA to enable it to effectively achieve its objectives and to provide specialised EDP and other technical support on a needs basis to all units;
- (6) PSB in conjunction with DMB give recognition to internal audit as being an essential aid to executive management by ensuring that an adequate establishment, career path and salary structure is available throughout the public sector; and
- (7) organisations unable to support an economically viable internal audit unit be serviced by the BIA.

### 3.3 Status of Internal Audit

#### CHARTER

- 3.3.1 Internal audit should have a charter covering the objectives, scope, responsibilities and authorities of the internal auditor which has been approved by the organisation and is understood throughout the organisation. The charter should provide for the independence of the internal auditor within the organisation by specifying that the internal auditor has no responsibility or authority for any activities audited. It should also cover the relationship of internal audit with specialist groups within the organisation as well as external parties such as the Auditor-General. Engagement letters should cover the employment conditions of private practitioners and include the above provisions of an internal audit charter.
- 3.3.2 The need for a charter stating the objectives, scope, responsibilities and authorities of the internal audit unit was clearly appreciated in those organisations having such a unit. Only 15 per cent of all organisations did not have either an internal audit charter or an engagement letter.

#### INDEPENDENCE AND OBJECTIVITY

- 3.3.3 Internal audit staff should be free from any operating responsibilities and should not be assigned to line function duties at any time.
- 3.3.4 The importance of internal audit staff being free from any operating responsibility which might compromise their independence and objectivity was appreciated in most organisations staffing their own internal audit unit. The review noted that 3 units (9 per cent) had defined operating responsibilities.
- 3.3.5 However in a number of other cases internal audit staff including private practitioners were occasionally given tasks involving design or implementation of systems or procedures which were not compatible with the internal audit role. In addition, the review noted that a number of private practitioners, performing the internal audit

function, were required by the organisation to prepare the annual financial statements. This reflects the lack of appreciation on the part of some executive heads of organisations of the importance of internal audit maintaining its independence from the systems and procedures it is evaluating or is required to evaluate.

#### CONSULTATION CONCERNING NEW SYSTEMS

3.3.6 The need for independence should not be confused with the need for internal audit to be consulted during the development of new systems and procedures. It is both appropriate and desirable that internal audit be able to provide general advice concerning necessary control features in any new systems and procedures being implemented. However internal audit involvement should generally only be in the early stages of design and certainly should not be so detailed that it becomes part of the design and implementation process thereby compromising audit independence.

3.3.7 In only 11 organisations (20 per cent) was internal audit not involved in this consultative process. However, the review noted that in others the involvement was too detailed.

#### RIGHT OF ACCESS TO RECORDS

3.3.8 The internal audit unit should have full access to all books and records relevant to the activity being audited and receive the complete co-operation of staff of the location or unit being audited.

3.3.9 The review did not note any instances where full access was not available to internal audit.

#### FREEDOM TO DETERMINE SCOPE AND ACTIVITIES

3.3.10 It is also important as part of the independence of the internal audit unit that it be free to select the activities to be audited, to determine the scope of audit coverage and to choose and apply its own procedures. Operational management being evaluated or reviewed by internal audit must not be capable of placing any restrictions on the work undertaken by the internal auditor.

3.3.11 Whilst certain organisations limit the scope of their internal auditor's activities eg. restrict the audit to cover only the attest audit, generally no restrictions are placed on the audit coverage once the internal auditor's plan has been approved and the audit commenced. However in the case of the Victorian Economic Development Corporation the scope and activities of the internal auditor are determined by the Finance Manager.

#### REPORTING

3.3.12 To maintain a high level of independence, internal audit should be responsible to the Chief Administrator or the General Manager of the organisation and report directly to that person. Internal audit should have access to the executive head of the organisation who should co-operate in this regard. This arrangement will contribute to raising the status of the internal audit unit within the organisation and ensure co-operation from all staff of the organisation.

3.3.13 The review indicated that the access to executive management varies in practice. In all cases the internal auditor was stated as having at least an ultimate right of access to executive management concerning matters raised in reports. However in practice the general line of reporting varies significantly. In some cases the internal auditor reports directly to the executive head of the organisation on all individual audits. In other cases individual audit reports are sent to line management for action with only a quarterly or monthly report on all projects being sent to the executive head in a summarised format. The varying approaches reflect different degrees of involvement of executive heads in the work of the internal auditor. In organisations with audit committees (14 per cent) the reporting process was similar i.e. in some instances reporting was direct to the audit committee and in others the committee only received summary reports periodically.

#### Recommendations

3.3.14 Audit recommends that:

- (1) all organisations establish a charter covering objectives, scope and responsibilities and authorities of the internal auditor and that the charter be regularly reviewed;

- (2) executive management ensure that the employment of private practitioners is covered by an engagement letter which is subject to annual review; and
- (3) to ensure that the internal auditor is held in high regard by all personnel of the organisation, executive management should be fully supportive of the role and be approachable at all times.

### **3.4 Scope and Coverage of Internal Audit**

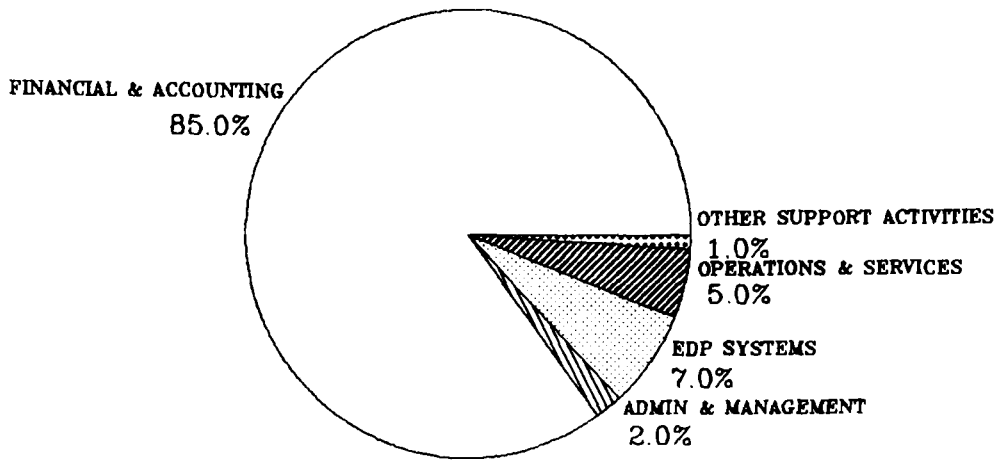
3.4.1 Internal audit is a major part of the control mechanisms within any organisation, its principal objective being to provide management with an independent and systematic appraisal of all aspects of operations within the organisation. The extent of the scope and coverage on operations by the internal audit is dependent to a large extent upon the size and structure of the organisation and the requirements of its management. In broad terms the scope of the audit should include:

- . a review of financial systems to provide an assurance to management prior to their attestation of financial statements
- . a review of procedures to ensure compliance with legislation, regulations, policies and internal directives and informing management of any departures from such requirements
- . a review of management processes in terms of economy, efficiency and effectiveness.

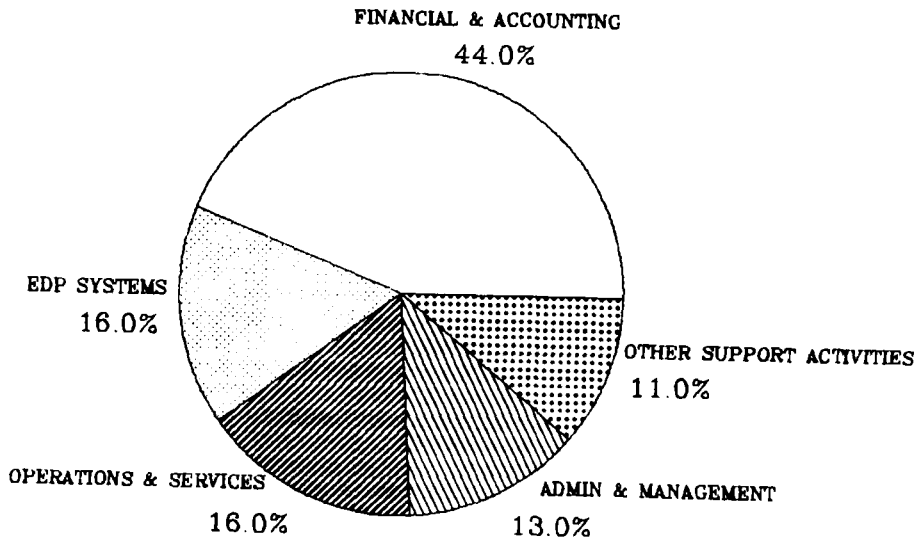
#### UTILISATION OF AUDIT TIME

3.4.2 As part of the review, an analysis was undertaken of the proportion of audit time spent by internal audit units on the different systems and functions operating within the organisation. The results of this analysis are shown in tables 1 and 2 on the following page.





**TABLE 1 : UTILISATION OF AUDIT TIME BY PRIVATE PRACTITIONERS ENGAGED AS INTERNAL AUDITORS**



**TABLE 2 : UTILISATION OF AUDIT TIME BY INTERNAL AUDIT UNITS STAFFED FROM WITHIN ORGANISATION**

3.4.3 Having regard to the potential audit risks which may emanate from computerised systems, the time apportioned to EDP audit was considered to be inadequate. This lack of involvement in EDP auditing is, to some extent, compounded by the difficulties which organisations encounter in recruiting and retaining staff with EDP expertise.

3.4.4 The high involvement of private practitioners on financial accounting systems is attributable to their engagement to perform an attest audit. In some cases the executive head had erroneously believed that the private practitioner had been engaged to assist the Auditor-General who would determine the work to be undertaken by the private practitioner during the year.

#### AUDIT APPROACH

3.4.5 The audit approach can be briefly described as a method of achieving audit objectives effectively and efficiently by relying heavily on a planned logical analysis of the strengths and weaknesses of an organisation's systems, supported by tests, to gauge the extent to which the controls can be accepted. The approach envisages auditors obtaining high levels of confidence from the effectiveness of internal controls in systems whenever it is economical and practical to do so.

3.4.6 The systems-based methodology has been utilised by the profession as established practice for many years. This approach recognises the continuing growth in the volume of financial transactions throughout the State.

3.4.7 Despite this, the review revealed that 5 internal audit units (16 per cent) continued to use the transaction-based methodology to a greater degree than the systems-based approach. Of some surprise was the high incidence of the use of transaction-based methodology by private practitioners (39 per cent) as transaction-oriented audit techniques are generally less cost effective in an environment of high volume transactions. As audit resources are scarce, testing transactions must be limited and only related to establishing the effectiveness of systems.

- 3.4.8 The adoption of systems-based auditing provides a more structured approach to auditing and provides internal audit staff with a better understanding of the financial and management systems within their organisation.

#### SCOPE OF AUDIT

- 3.4.9 An audit can be divided into 3 main components, namely, financial, regularity and value for money. Comprehensive auditing embraces these 3 components. This methodology is an extension of the systems-based approach and should not be seen as a new auditing approach.
- 3.4.10 The charter of each internal audit unit reviewed generally did not inhibit audit operations thereby permitting internal auditors to adopt the comprehensive audit approach. However, the emphasis of the audit is entirely at the direction of the executive head of the organisation and should result in the provision of the information considered necessary for the efficient and effective utilisation of resources under management control.
- 3.4.11 Eleven (34 per cent) of the 32 internal audit units staffed from within the organisation reviewed devoted insufficient time to the financial audit whereas 26 units (81 per cent) devote some time during their audits to value for money aspects. However the review concluded that the audits undertaken on value for money projects could only be relied upon in 7 of these units. With the exception of 2 organisations, private practitioners were engaged to undertake a financial audit only.
- 3.4.12 All internal auditors indicated that audit examination of operations to ensure compliance with legislation, regulations and procedural directives was carried out during the year.

#### ADEQUACY OF EDP COVERAGE

- 3.4.13 Considering the substantial expenditure on the development of computerised information systems within the public sector and the increasing reliance by management on such systems, it is essential for management to seek periodic assurances that the controls within the

computerised systems are adequate. Management must therefore turn to internal audit to provide this assurance and, as a consequence, it is essential for the unit to have staff possessing appropriate EDP expertise and to be supported by adequate technical resources.

3.4.14 An area of concern highlighted during the review was the low proportion of time spent on auditing EDP systems in a number of organisations. There was no involvement by internal audit in the EDP systems at the Grain Elevators Board, Rural Water Commission and the Port of Melbourne Authority and several smaller organisations audited by private practitioners. In 13 other organisations (25 per cent) the involvement did not exceed 10 per cent of total audit time.

3.4.15 Of the 32 organisations with their own internal audit units, only 12 (37 per cent) were providing a satisfactory audit coverage of EDP systems. Of those considered satisfactory the time devoted to the audit of EDP systems was approximately 25 per cent. The remaining units (63 per cent) indicated that their staff did not possess the necessary skills to undertake effective reviews of controls within computerised systems nor did they have the expertise to make use of computer packages to aid them in conducting the audit. The inadequacy of internal audit involvement in the audit of EDP systems may place management of those organisations at risk as they are not provided with an independent assurance on a regular basis of the systems integrity.

#### 3.4.16 Recommendations

Audit recommends that:

- (1) systems-based audit methodology be adopted by all internal auditors including contracted private practitioners in the public sector to ensure efficient and effective utilisation of scarce resources;
- (2) in conjunction with the BIA, executive management should continue to seek audit personnel with appropriate EDP skills and expertise so as to provide management with an assurance on the integrity of data maintained by the organisation's computerised systems; and

- (3) consideration be given to the purchase and/or development of computer assisted audit techniques (CAATS) to assist internal auditors in achieving a cost effective audit of computerised systems.

### **3.5 Planning Execution and Reporting**

#### AUDIT PLANS

3.5.1 One of the major responsibilities of the internal auditor within an organisation is to develop adequate plans for the operation of the internal audit unit. In developing these plans, consideration should be given to the following:

- . defining the total audit responsibility
- . ranking audits in order of priority
- . preparing long-term strategic plans
- . preparing annual audit plans and programs.

3.5.2 Internal audit cannot expect to be effective until clear objectives have been determined and proper planning processes are in place. The objectives must ensure the needs of the organisation are met. In large organisations it will not be possible for the internal audit unit to provide a total coverage of all activities of the organisation each year. Therefore, in addition to developing detailed annual plans, it will also be necessary for internal auditors to develop longer-term plans covering, for example, periods of 3-5 years. The internal auditor through effective planning can ensure the organisation receives the greatest benefit from the resources available to the unit. Auditable areas identified within the total field must therefore be ranked in order of priority and this assessment should provide the basis for determining the most effective annual audit plan. In making such an assessment the internal auditor should consider many factors such as audit risk, materiality, changes within the organisation, complexity of systems, previous audits conducted by the unit, requirements of the executive head, work undertaken by other auditors such as the Auditor-General and any other special factors which may occur at particular times.

- 3.5.3 Having developed strategic and annual plans it is essential that the plans be approved by the executive head, the board or its chairperson or the audit committee if one has been established. The plan may be departed from at a later date, at the direction of one or all of these, but plans should not be varied for other reasons without reference to those who originally approved of them. It is also important that progress against the approved plan be closely monitored by the internal auditor and executive head of the organisation.
- 3.5.4 In organisations where private practitioners are engaged as internal auditors, the audit plans were usually developed prior to the commencement of the audit. Generally these plans addressed all aspects of the financial systems but only 57 per cent considered priority when determining audit coverage of activities. Notwithstanding the fact that the organisation engaged private practitioners to undertake an audit on their behalf and therefore should have been involved in the approval of any audit plans, the review noted that there was no involvement by the organisation in the approval process.
- 3.5.5 The review also indicated that all organisations with their own internal audit units had some form of audit plan in place. Twelve internal audit units (37 per cent) indicated that both annual and long term strategic plans had been prepared. Of the remaining 20 units (63 per cent) 3 had long term strategic plans and 17 had developed short-term plans ranging from 6 to 12 months. In 13 organisations (41 per cent), internal audit advised that the audit plans addressed all activities of the organisation whilst the remaining 19 (59 per cent) had only considered part of the organisation's activities. In addition, the internal auditors of 6 organisations (19 per cent) did not rank the areas to be audited in the order of priority.
- 3.5.6 The failure to identify and prioritise all areas of activity to be subject to audit will result in an ineffective coverage of the organisation's operations. Likewise, the failure to prepare long-term strategic plans may result in the same activities being audited each year without due regard being given to the total operations of the organisation. This approach does not take into account perceived audit risk and materiality and therefore may leave management exposed to risk.

3.5.7 As indicated earlier in the report the status of the internal auditor within the organisation can be improved if the executive head of the organisation provides the necessary support to the unit. It is therefore important that the executive head, the board or the audit committee approve the internal audit plan each year. Audit noted that the internal auditor of the State Electricity Commission, the Gas and Fuel Corporation, the Ministry for Education, the Department of Conservation, Forests and Lands, Melbourne University and the Melbourne and Metropolitan Board of Works approved their own audit plan and in 3 of these instances the plan was referred to the appropriate level for information purposes. Generally, variations from the approved plan were minimal and it was usually at the request of the executive head of the organisation that such variations occurred.

3.5.8 Progress against the approved plan was monitored in 25 organisations (78 per cent), however in some instances this process did not occur frequently enough. In 7 organisations (22 per cent) no monitoring was undertaken.

#### PROCEDURAL MANUAL

3.5.9 It is important that internal audit units have an audit manual which illustrates how internal audit will fulfil the objectives of its charter. The manual should provide the necessary guidance to staff in undertaking audits within the organisation. It should therefore include sections on auditing standards and practice, audit methodology such as systems-based auditing, E.D.P. auditing, working papers, planning procedures, quality review processes etc.

3.5.10 The audit review indicated that 19 organisations (59 per cent) with their own internal audit unit had not developed an audit manual incorporating policy and procedures to be followed. Reasons offered by these organisations for not having an audit manual included:

- . number of staff too small to warrant production of a manual
- . unit only recently established
- . unit is making use of a manual devised by another organisation

- . organisation has developed audit programs which provide a step by step guide to conducting the audit.

3.5.11 The absence of an audit manual leads to an inconsistent approach to the conduct of audits and makes an evaluation of audit performance difficult.

#### AUDIT FREQUENCY

3.5.12 Generally it is necessary for internal audit units to develop an audit cycle as all activities and systems cannot be audited every year. Factors which should be taken into account in developing a 3-5 year cycle include conditions found in the previous audit, performance reflected in management reports, transaction volume in financial terms and adequacy of internal control within the organisation. Of the organisations with their own internal audit units covered by the review only 2 used inadequate criteria in determining audit frequency. Those organisations relied on judgement and did not make any variation to a set audit cycle.

#### NUMBER OF AUDITS PERFORMED

3.5.13 The review sought to determine how internal audit units apportioned their time between small audits (up to 1 person week), medium audits (between 1 and 5 person weeks) and large audits (more than 5 person weeks). The number of audit assignments undertaken during the 1983-84 financial year within the organisations reviewed totalled 3752 with an overwhelming tendency towards small audits (2987), followed by medium (552) and large (213). The majority of the small audits were undertaken by 3 large organisations, the Totalizator Agency Board (1660), the Ministry for Education (596) and the Gas and Fuel Corporation (250). In fact, these organisations undertook approximately 75 per cent of the audits conducted by internal audit units during 1983-84 but employed only 22 per cent of the total internal audit staff. The scope of the audit within these organisations is heavily concentrated on specific activities such as agency cash audits (Totalizator Agency Board) and school audits (Ministry for Education) hence the large number of audits of less than 1 person week undertaken.



## RELATIONSHIP WITH EXTERNAL AUDIT

- 3.5.14 Heads of most internal audit units consider that their relationship with external audit (Auditor-General) is good. In most instances the organisation's charter addresses the need for co-operation with the external audit staff and the co-ordination of auditing activities to ensure the most cost effective audit of the organisation is achieved.
- 3.5.15 The review indicated that the area of most concern to the internal auditor in their relationship with the external auditor was audit planning. Generally it was considered there was a need for more effective communication during the planning process to ensure a co-ordinated approach to the proposed auditing activities for the year. As mentioned earlier in this report almost every executive head interviewed during the review agreed to participate in a meeting with internal and external audit staff prior to the commencement of the annual external audit. This type of meeting will provide the forum for discussion of the proposed audit coverage by both internal and external audit thus eliminating any unnecessary duplication and facilitating the achievement of a more cost effective audit for the organisation. It will also ensure that internal audit coverage of a particular function or activity is complementary to external audit objectives.

## PERFORMANCE OF INDIVIDUAL ACTIVITIES

- 3.5.16 The efficient performance of any audit assignment requires careful planning of the work to be undertaken, the setting of specific attainable objectives and the development of a written detailed work plan in advance of the audit of each particular activity. It is also important that sufficient background information is obtained relating to the specific activity being audited and that the auditor is conversant with relevant legislation and directives applicable to the area being audited.
- 3.5.17 The review indicated that the internal audit units of 48 organisations (91 per cent) had developed adequate audit plans and set attainable objectives in advance of conducting specific activities. In 4 organisations, the Road Traffic Authority, the Stamp Duties Office,

Deakin University and Emerald Tourist Railway Board detailed written audit plans covering the activity to be audited did not exist. One organisation, recently established had not yet prepared audit plans.

3.5.18 The execution phase covers the physical conduct of the audit. The questionnaire used to gather information for the purpose of the review sought to ascertain the audit methodology used i.e. systems-based or transaction-based and how the level and type of testing was determined. It also addressed whether management and internal controls were audited, whether control deficiencies were identified in the review process, whether key controls were operating as designed and whether the causes of weaknesses in controls were identified by internal audit. The review concluded that generally an adequate coverage was given by internal audit to specific areas of organisational activity at a given point in time e.g. a payroll audit covering one month only provides an assurance for that month and not for the payroll system over the complete year. Therefore this approach limits the degree of assurance that can be provided to management by internal audit on the operations of various systems within the organisation during the period covered by the financial statements. As a consequence this limitation has impacted on the audit coverage by external audit and has resulted in duplication of effort and additional costs to the organisation.

3.5.19 Reporting is the final phase where audit findings are communicated to senior management in order that the appropriate corrective action can be taken. No matter how effective the audit may have been its impact will depend almost entirely on the effectiveness of the report. It is therefore important that the report be concise and contain meaningful comments and recommendations. Reports should be forwarded to management in a timely manner and an adequate follow-up system should be in place within the internal audit unit to ensure internal audit reports are considered and acted upon by management. Following the adoption of audit recommendations, management should ensure that the effectiveness of any corrective or preventive action taken is monitored.

- 3.5.20 The review concluded that reports submitted by internal audit on specific activities were satisfactory and that there was adequate follow-up systems in place within 85 per cent of the internal audit units. Senior management of all organisations covered by the review considered the recommendations in reports from the internal auditor. Approximately 70 per cent of all audit recommendations were acted upon by management.
- 3.5.21 Only 12 per cent of internal audit units monitored the corrective action taken by management on audit recommendations in a timely manner; 56 per cent considered it when the activity was next audited. The remaining units did not have a satisfactory system in place to ensure that corrective measures taken by management were evaluated.
- 3.5.22 On the other hand, approximately 95 per cent of private practitioners ensure that corrective measures taken by management are monitored.
- 3.5.23 External audit was able to place reliance on the work undertaken and audit conclusions arising from the examination of specific activities conducted by internal audit units. However, this reliance was of little value to external audit when reaching an opinion on the annual financial statements of a number of organisations covered by the review due to the limitations in audit approach mentioned earlier in this section.
- 3.5.24 The work of all private practitioners for the purpose of planning the external audit was considered satisfactory.

#### Recommendations

- 3.5.25 Audit recommends that:
- (1) executive management, the audit committee or board approve the plans of the private practitioner prior to the commencement of the audit year to ensure the service provided is compatible with management's objectives and complementary to the external audit;

- (2) all internal audit units staffed from within the organisation prepare annual and strategic audit plans taking into account all areas to be examined having regard to audit risk and materiality and that they be approved by either the executive head, the board or the audit committee if one exists;
- (3) priority be given to the development of an audit manual incorporating audit standards and practice, audit methodology, EDP auditing, planning procedures etc. for use in the Victorian public sector;
- (4) communication during the planning process between internal audit and external audit be improved to ensure a co-ordinated approach to the auditing activities for the year;
- (5) corrective action taken by organisations on recommendations made by internal audit on specific activities should be regularly monitored to ensure that the relevant systems and management controls are operating satisfactorily and that any anticipated savings identified are achieved; and
- (6) in accordance with the preferred role of internal audit recommended by the BIA, internal audit activity should centre around programs with emphasis on the efficiency, economy and effectiveness of the internal management practices and controls. The service provided by internal audit to management should encompass such matters as:
  - . integrity of information
  - . compliance with legislation, policies and directives
  - . security and management of assets
  - . economy and efficiency in the use of available resources
  - . effectiveness of operations.

### **3.6 Management of Internal Audit Function**

3.6.1 The efficient and effective operations of an internal audit unit are dependent to a large extent on the proper utilisation of resources made available to the unit. In this regard it is essential that proper budgets are established for each audit activity and that actual times recorded by staff are closely monitored by internal audit management.

3.6.2 All audit operations must be adequately supervised by experienced, qualified staff. The results of each audit must be supported by appropriate audit evidence which has been subject to a quality review by the internal audit head prior to the presentation of the audit report to management.

3.6.3 Of the 32 organisations with their own internal audit unit reviewed only 12 units (37 per cent) had proper management information systems in place to ensure actual times were regularly monitored against approved budgets for each area of audit activity. The failure of the remaining 20 units (63 per cent) to properly record and monitor audit performance is of concern and may result in the ineffective use of scarce resources. In all units there was adequate documentation provided in the audit process which, with the exception of Deakin University, was reviewed by senior audit personnel. All audit activity was closely supervised by the internal audit head in 91 per cent of the organisations reviewed. However, a quality assurance program to ensure all audit activity was supported by appropriate audit evidence and in accordance with internal audit standards, was only in place in 25 per cent of units reviewed.

#### Audit Recommendations

3.6.4 Audit recommends that:

- (1) an appropriate management information system be established incorporating budget and actual times on each audit activity contained within the approved annual plan. Actual times should be closely monitored against budget times to ensure effective utilisation of resources within the unit; and
- (2) a quality assurance program be developed by each internal audit unit to ensure that all audit activities are supported by appropriate audit evidence and that such audits have been conducted in accordance with auditing standards.

### **3.7 Central Agency Support for Internal Audit**

3.7.1 The review sought to determine the extent to which the BIA and PSB have provided support for each internal audit unit and areas where the internal audit head considered assistance or advice could be provided to improve the effectiveness of the unit.

3.7.2 Comments received from internal audit heads of organisations indicated that the BIA had been in contact with 41 per cent of internal audit units reviewed. Advice given by the internal auditor on BIA assistance provided to the unit included:

- . invitations to internal audit seminars conducted by BIA
- . provision of interim standards on internal audit
- . advice on training
- . assistance with staff selection
- . provision of professional advice on request
- . secondment of staff.

3.7.3 Nine per cent of internal audit heads indicated that some advice had been received from PSB on such matters as role statements and various training courses.

3.7.4 At the time the information was sought internal auditors indicated that the role of BIA should encompass:

- . support and technical advice on EDP audits
- . access to a pool of auditors including specialists in EDP
- . provision for information on current developments in internal audit
- . secondments of staff to and from BIA
- . establishment of forum to discuss internal audit issues
- . provision of policies and procedures manuals for internal audit units within the public sector
- . promotion of the image and role of internal audit within the public sector
- . access to a data-base on issues raised in audit reports.

- 3.7.5 It is recognised that there has been an overall upgrading of the level of classification of personnel within the internal audit sector in recent years. However, heads of internal audit units consider that their staffing structures are still not adequately classified and that there is no satisfactory career path for internal auditors. They consider the PSB has a role to play in addressing these issues.
- 3.7.6 Due to the limited opportunities within individual units of participating in professional development programs, it is important that these opportunities are provided by central agencies. In this regard BIA has conducted training courses and recently initiated seminars and special interest group meetings to increase the awareness of opportunities for internal auditors. Specialist training courses in all fields relevant to internal audit are planned for the future and management courses for senior audit personnel have been conducted by the BIA.
- 3.7.7 Many internal auditors expressed the desire to attend training courses conducted by the Office of the Auditor-General.

#### Audit Recommendations

- 3.7.8 Audit recommends that:
- (1) the BIA broaden its role to cater for user needs as well as giving high priority to providing the necessary advice and expertise in areas identified by particular units such as EDP, procedure manuals, promotion of image, role of internal auditors and professional development; and
  - (2) the BIA ensure it provides access to its services and expertise to all public sector organisations and that the head of the BIA promote the image of internal audit with executive management and ensure all managers are aware of the need to establish and support internal audit due to the benefits the organisation can obtain from a dynamic internal audit unit.

### **3.8 Audit Committee**

3.8.1 The establishment of audit committees in the public sector in Victoria is in its infancy. The audit committee's specific objectives should vary depending on the organisation's circumstances and expectations. An important role of an audit committee is to ensure audit activities are both appropriate and properly carried out thus avoiding duplication of effort. In general terms an audit committee should operate as a sub-committee of the governing board in matters delegated to it by the board. As a result significantly more time can be devoted to the matters it has responsibility for such as audit planning, external reporting and consideration of internal and external audit reports.

3.8.2 To be effective it is important an audit committee:

- . has a clear statement of its objectives
- . is composed of personnel possessing the appropriate skills and expertise
- . has the full support of management.

3.8.3 Nine organisations (17 per cent) had established an audit committee. In the other organisations there were varying degrees of understanding of audit committees by executive heads. Some had no knowledge of such committees whilst others had considered their establishment but determined that they were not necessary at this point in time.

#### Audit Recommendation

3.8.4 Audit recommends that all major departments and public bodies give consideration to the establishment of an audit committee with some representation on it being obtained from outside the organisation.

### **3.9 Acknowledgement**

3.9.1 Appreciation is expressed to the many executive heads and internal auditors from within the public sector together with private practitioners undertaking the internal audit function on behalf of particular organisations who participated in the review.



**LIST OF ORGANISATIONS INCLUDED IN REVIEW**

**(1) Departments and Branches**

(i) Internal audit function staffed from within the entity

Department of Agriculture and Rural Affairs  
Department of Community Services  
Department of Conservation, Forests and Lands  
Ministry of Education  
Health Department Victoria  
Ministry of Housing  
Law Department  
Department of Management and Budget  
Public Works Department  
Department of Sport and Recreation  
Stamp Duties Office

(ii) No internal audit function

Ministry for the Arts  
Ministry of Consumer Affairs  
Ethnic Affairs Commission  
Victorian Government Printing Office  
Department of Industry, Technology and Resources  
Department of Labour  
Local Government Department  
Ministry for Planning and Environment\*\*  
Ministry for Police and Emergency Services  
Department of Premier and Cabinet  
Department of Property and Services\*\*  
Ministry of Transport  
Department of Water Resources

**(2) Public Bodies**

(i) Internal audit function staffed from within entity

Accident Compensation Commission  
Country Fire Authority  
Deakin University  
Gas and Fuel Corporation  
Grain Elevators Board  
Latrobe University  
Melbourne and Metropolitan Board of Works  
University of Melbourne  
Metropolitan Transit Authority  
Monash University  
Motor Accidents Board\*  
Port of Melbourne Authority

Road Construction Authority  
Road Traffic Authority  
Rural Water Commission  
State Electricity Commission  
State Insurance Office\*  
State Superannuation Board  
State Transport Authority  
Totalizator Agency Board  
Victorian Dairy Industry Authority

(ii) Internal audit function provided by private practitioner

Bendigo College of Advanced Education  
Cancer Institute Board  
Chisholm Institute of Technology  
Collingwood College of TAFE  
Emerald Tourist Railway Board  
Geelong Performing Arts Centre Trust  
Hospitals Superannuation Board  
Metropolitan Fire Brigades Superannuation Board  
Port of Geelong Authority  
Prahran College of TAFE  
Royal Melbourne Institute of Technology Ltd.  
Rural Finance Commission  
State Employees Retirement Benefits Board  
Shepparton College of TAFE  
Tattersall Sweep Consultations  
Victorian Arts Centre Trust  
Victorian Economic Development Corporation  
Victorian Egg Marketing Board  
Victorian Nursing Council  
Victorian Tourism Commission  
William Angliss College of TAFE

(iii) No internal audit function

Harness Racing Board  
Legal Aid Commission\*\*  
Marine Board of Victoria  
Urban Land Authority  
Victorian Prison Industries Commission

\* have private practitioner as well as own internal audit unit

\*\* internal audit unit established subsequent to the review