

The Institute of Internal Auditors – Australia

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Senator the Hon. Ian Campbell
Parliamentary Secretary to the Treasurer
Parliament House
CANBERRA ACT 2600

14 March 2002

Dear Senator Campbell

The Institute of Internal Auditors – Australia (IIA-Australia) appreciates the opportunity to offer comments on the findings and recommendations of the ***Independence of Australian Auditors review (Ramsay Report)***.

We were pleased to discuss the value of internal audit in a corporate governance framework with Professor Ramsay during the course of the review. We appreciated the time you spent with us in discussion, and would be pleased to discuss our recommendations and comments with you in further detail if required. We believe that our comments are a balanced representation of the views of our membership.

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

We have focused our response on recommendations that are of interest to internal auditors, particularly the material contained in *sections 5.60 - 5.94* in the *Ramsay Report*. We have also included comments on the importance of an effective internal audit function in a corporate governance structure and why we believe that any outsourcing of the internal audit function to the external audit firm will compromise the independence of that firm.

Yours sincerely

Christopher McRostie
Executive Director

RECOMMENDATIONS

Audit Committee

1. That the Audit Committee be comprised of non-executive directors only. The Chief Financial Officer, the Chief Executive Officer and other managers with executive and operational responsibilities should be specifically excluded from the committee and to avoid any conflict of interest, they should attend meetings of the committee by invitation only.
2. That it be mandatory for all publicly listed companies to have an Audit Committee. The Audit Committee's responsibilities would be those as detailed in the *Audit Committees Best Practice Guide*.¹ It should be the Board Audit Committee that sets the scope of the internal audit, with the assistance of the head of internal audit, not the CEO or other members of the senior management team. A means of assisting this process is to have a rolling Internal Audit plan of review which incorporates those areas to be reviewed annually, biannually etc.

Internal Audit Function

3. That it be a requirement for all publicly listed companies to have an Internal Audit function which may be internally/externally sourced, reporting to the Audit Committee. It is essential that when the internal audit function is externally sourced, that the organisation has an internal, Internal Audit management team to define and direct the scope of the work to be undertaken.
4. That internal audit functions within Australian companies adopt the IIA Inc *Standards for the Professional Practice of Internal Auditing*, as they are standards applied globally by IIA members in over 100 countries.
5. In line with our definition of internal auditing (see addendum A/page 8), the internal audit function as directed by the Audit Committee, must review all aspects of an organisation including corporate governance, risk management, control, assurance etc. This is to avoid any restriction being placed by organisations on the scope of the internal audit function. It should be mandatory that audit committees report against the areas listed below as a minimum and that they report on the role played by internal audit in each of the four areas below.

For example,

5.1. Risk management

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

5.2. Control

The issue of Control Review should be clearly set out in the Audit

¹ AARF, AICD, IIA-Australia *Audit Committees: Best Practice Guide* 2nd edition, Sydney, 2001

Committee/Internal Audit Charters so that the management of the organisation is very clear on the access and coverage of the function.

5.3. Assurance

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

5.4. Organisational governance processes

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

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

Outsourcing

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

If this recommendation is not accepted then

6.1 It should be reported in the Annual Report if Internal Audit is outsourced/co-sourced, to whom and whether the same firm undertakes the external audit; and how independence is maintained in the event of the same firm undertaking internal and external audit functions. See point 5.4 above.

6.2 Audit Committees need to evaluate extended and non-audit services conducted by their audit firm. We recommend that audit committees should be encouraged to evaluate extended audit services and that disclosures in the statutory financial statements should be required in legislation to list and itemise non audit services provided by a firm's external auditors to its audit client. The fees derived from the provision of internal audit services should be a separate category in the list, especially if the internal audit function was to be out sourced either to the external audit firm or to any other firm.

7. Similarly, where the internal audit function is outsourced, then the outsourcing firm should provide no other consulting services, including external audit. This is to ensure that independence is maintained.

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7.1 It should be reported in the Annual Report if Internal Audit is outsourced/co-sourced, to whom and whether the same firm undertakes the external audit; how independence is maintained in the event of the same firm undertaking internal and external audit functions. See point 5.4 above.

Recognition

8. That Internal Audit be recognised as a separate profession from external audit, as the skill base is far more diverse than for external audit; as it has its own *Code of Practice*; and as it has its own *Standards for the Professional Practice of Internal Auditing*.
9. That Internal Auditors be registered (in a similar way to External Auditors). It is suggested that the criteria for registration be compiled by the IIA-Australia and ASIC and that supervision of Registered Internal Auditors be conducted by a joint committee of ASIC and IIA-Australia.

ADDENDUM A

Review of recommendations – section 5.94

We note that Professor Ramsay recommends that the provision of non-audit services by audit firms to their clients be dealt with in several ways:

- a) by revised and updated professional ethical rules;
- b) by mandatory disclosure of non audit services and the fees paid for these services;
- c) by strengthening the role of audit committees; and
- d) by establishing an Auditor Independence Supervisory Board, which would have, among its functions, the task of monitoring the adequacy of disclosure of non-audit services.

a) Revised and updated professional ethical rules

The Institute believes that revising and updating the professional ethical rules is a valuable step in improving awareness of independence issues amongst the membership of the professional accounting bodies.

b) Mandatory disclosure of non-audit services and the fees paid for these services

We note that Professor Ramsay does not define the categories of non-audit services to be disclosed (either as part of an amendment to the *Accounting Standards* or Chapter 2M of the *Corporations Act*). The Institute recommends that internal auditing services should be listed as a separate category of non-auditing services. Internal audit is recognised as a “self review threat” (ie a service that may pose a threat to an auditor’s independence) in the International Federation of Accountants’ list of non-audit services.

The Institute recommends that internal auditing services should be listed as a separate category of non-auditing services.

c) Strengthening the role of audit committees

We applaud the recommendation to strengthen the role of the audit committee. The Institute, along with the Australian Institute of Company Directors and the Australian Accounting Research Foundation, recently issued a second edition of *Audit Committees: Best Practice Guide* in August 2001. We believe that the potential for audit committees to dramatically improve corporate governance and promote ethical business decision-making has not been realised by the contemporary practices of large organisations. The Institute believes that the appropriate reporting structure for the internal audit function is to the audit committee. As the role of internal audit has broadened to include consulting, risk management and the way work is performed, it is critical in our view to ensure that the reporting system allows the function to be free and frank in its assessment and reporting.

The Institute believes that the appropriate reporting structure for the internal audit function is to the audit committee.

d) Auditor Independence Supervisory Board

The composition and role of the Auditor Independence Supervisory Board as laid out in the Ramsay Report is also supported by the Institute. It has been noted that the composition of similar bodies overseas tended to be dominated by the professional accounting bodies and public accountants. The views of the proposed Board should not be influenced by the significant commercial interests of the "Big 5". The Institute believes that the proposed composition is appropriate to ensure a broad cross section of views. We suggest that one of the Board's first activities should be to clearly state that external auditors cannot provide any other services to their audit clients. We contend that in providing internal auditing services or other consultancy services, the independence (perceived or real) of external auditors will be compromised.

The Institute suggests that one of the Board's first activities should be to clearly state that external auditors cannot provide any other services to their audit clients.

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

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

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

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The nature of contemporary internal auditing

Internal auditors are "business generalists" who specialise in the efficiency and effectiveness of internal audit for the good of the organisation and its stakeholders. Their roles include monitoring, assessing and analysing organisational risks and controls and reviewing and confirming information and compliance with policies, procedures and laws. Working in partnership with management, internal auditors provide the board, the audit committee and executive management with assurance that risks are held at bay and that the organisation's corporate governance is strong and effective.

The nature of internal auditing has changed dramatically over the last 10-15 years. Anecdotally, our members have indicated that they are increasingly called upon to perform more work of a consulting and prospective review nature. For example, internal auditors may examine proposed policies and procedures, proposed internal controls and offer opinion on how proposed changes will impact the overall risk profile of the organisation.

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

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

As internal auditing becomes more and more involved in risk management and governance processes, internal auditing becomes less and less compatible with the role of the independent external auditor².

The total outsourcing of the internal auditing function will impact external auditor independence

It is important that the external auditor is independent of its client.

It is important that the external auditor is independent of its client and as AUP 32³ points out "internal audit is an integral part of an entity's organisation and functions under the policies established by the governing body with the objective of assisting that body in the effective discharge of its responsibilities."

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

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

² In its final ruling over Auditor Independence Requirements, the Securities and Exchange Commission in the US described internal auditing's relationship with management as "part of the management team... basically, an arm of management" and "part of a company's internal accounting control system."

³ Auditing and Assurance Standards Board of the Australian Accounting Research Foundation, February 1999, "AUP 32 Audit Independence", paragraph 45. Note that this professional Statement serves as guidance only and does not require mandatory compliance.

*Australian Auditing Standard 604 "Considering the work of internal auditing"*⁴ requires the external auditor to assess the effectiveness of the internal auditing function and the impact (if any) on control risk.

The external auditor is required to assess:

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

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

⁴ Auditing Standards Board of the Australian Accounting Research Foundation (October 1995), "AUS 604 – Considering the Work of Internal Auditing". Note that compliance with the black letter clauses in the Standard (as paraphrased above) is mandatory for members of the Institute of Chartered Accountants in Australia and CPA Australia.