

Achieving High Performance in Internal Audit

Australia 2009

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Risk & Business Consulting.
Internal Audit.



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Key Messages



Christopher McRostie
Chief Executive Officer
**The Institute of Internal Auditors
Australia**

Welcome to the 2009 benchmarking study.

The IIA's vision for the profession is for it to be universally recognised, trusted and respected as the leading provider of assurance and advice on risk management, internal control and governance, and this study provides some useful signposts for all of us in achieving that goal.

In reading the results, I am struck by two things.

Firstly, the significant majority of internal audit functions have moved from under the wing of the finance function and into the spotlight of the CEO and audit committee. This is a great achievement, but is also a double edged sword and not to be taken lightly. Pressures on CEOs and non-executive directors continue to evolve, and we must keep pace with them if we are to meet expectations. As a profession, internal audit must be an intellectual exercise and strong engagement with leading CEOs and audit committees will help us achieve this.

Unfortunately, too many internal audit functions are still reporting to the CFO or a level of management which can compromise internal audit independence. In this day and age, it is simply not appropriate and rightly, questions need to be asked of these organisations as to why they think that this is acceptable.

Secondly, while the survey shows that there is almost universal acceptance that factors like adherence to the IIA Standards, independent quality assessments, active membership of relevant professional bodies and appropriate qualifications are important, we still have

a long way to go with putting them into practice. Anyone holding themselves out to be an internal auditor needs to assess themselves against these factors, if we are to be taken seriously as a profession.

I would like to thank Protiviti for all of their work in putting the study together – this project would not have been possible without them. Importantly, I would also like to thank those who participated, and wish you all well as we strive to be universally recognised as truly world-class in all that we do.



Christopher McRostie
CEO, The Institute of Internal Auditors



Key Messages



Gary Anderson

Managing Director

Protiviti

Protiviti is pleased to support this important study that provides useful insights into the state and direction of the internal audit profession in Australia.

The study encouragingly shows that the role of internal audit is expanding, with the vast majority of organisations having increased the scope of their internal audit activity in recent years. Challenging economic times demand more vigilant governance and it is appropriate that organisations are using internal audit to review their operations more extensively.

It is also clear that the financial crisis has prompted many organisations and their internal auditors to sharpen their focus on risk management and mitigation. In this environment, internal auditors need to be proactive and use their expertise to assist boards and management to steer their organisations through difficult times.

The growing importance that organisations are placing on internal audit has been attributable in part to the rising professionalism of internal auditors. A significant majority of internal auditors now recognise that the best way to ensure quality in their internal audit activity is by complying with the International Standards for the Professional Practice of Internal Audit ('the *Standards*'). Moreover, a large number of internal auditors are consistently updating their skills through continuing education programs available through their membership with the Institute of Internal Auditors (IIA).

Still, with less than half of organisations currently fully adhering to the *Standards*, there is some way to go before the profession achieves its goal of full, across the board compliance. This is clearly an area the profession must work on if it hopes to further enhance its standing with senior decision-makers and other stakeholders.

Another major issue emerging from the study is that senior executives such as the Chief Financial Officer are exerting too great an influence over the internal audit function to the point where the objectivity and independence of the internal audit risks are being compromised.

Best practice dictates that decisions relating to the hiring and firing, remuneration and performance of the Head of Internal Audit must ultimately rest with the Audit Committee Chair. Substantive reporting lines for the Head of Internal Audit must also lead to the Audit Committee Chair.

Directors should recognise that for internal audit to be a source of reliable information to help the board meet its governance duties, it must not be captured by management. Internal auditors and Audit Committee Chairs should strive to ensure that internal audit charters reflect these fundamentals. Internal audit professionalism is again relevant, as the greater the value and expertise boards perceive in their internal audit function, the more disposed they will be to champion their independence.



Gary Anderson
Managing Director, Protiviti

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Executive Summary

Executive Summary

Internal Audit: Accelerating Strong Governance

Recent research conducted by Protiviti and the Institute of Internal Auditors – Australia (IIA) with chief audit executives from over 150 organisations in the public and private sectors highlights that organisations must address a number of issues to enable their internal audit function to more effectively advance good corporate governance.

Specifically the research found:

- a significant number of internal audit functions lacked the appropriate framework to operate independently and objectively
- an excessive level of influence is exercised by executive management over audit committee activities and the oversight and management of the internal audit function
- the majority of internal audit functions are unable to demonstrate compliance with the International Standards for the Professional Practice of Internal Auditing (*Standards*).

As you review this report, you should ask yourself:

- Are the governance structures for your internal audit function sufficient to allow your organisation to have a truly independent and objective internal audit function?
- How is your organisation placed to respond to the emerging trends facing internal auditors?
- How are you driving quality in your internal audit function and is it aligned to the *Standards*?
- How are you addressing key competency gaps within your internal audit function?
- Is Internal Audit really meeting the needs of your stakeholders?

Authority, Independence and Mandate

Internal audit encompasses much more than traditional financial auditing. It is rapidly becoming an arm of the board that provides independent assurance over the management of business risks. To be effective, this function needs to be free from undue management influence. Yet, according to our research, internal audit's functional reporting line to the board, or equivalent governing body, is compromised by excessive influence from executive management.

For example, the Chief Financial Officer is the final decision-maker in listed companies for:

- appointing or removing the Chief Audit Executive (CAE) – 15%
- evaluating the CAE's performance – 27%
- approving the scope of the organisation's internal audit – 21%

This is clearly out of line with contemporary and better practice.

However, there are a number of encouraging practices in this area including:

- 64% of listed companies stated that their audit committee chair is the final decision-maker for the appointment or removal of the CAE
- 58% of government organisations reported that their chief executive or equivalent is the final decision-maker for CAE appointments and removals
- 64% of listed companies stated that their audit committee chair is the final decision-maker for the approval of the internal audit function's scope and budget.

An ongoing relationship between the audit committee chair and the CAE is essential to good governance. Yet, one third of CAEs do not hold private meetings with the audit committee chair and/or the audit committee.

While best practice is now increasingly the norm, there is still room for improvement particularly for listed companies. In the public sector, good practice is demonstrated by the fact that the internal audit function in a significant proportion of organisations reports to the chief executive equivalent or the audit committee. The challenge for the public sector is to ensure that

Executive Summary

audit committees work effectively and provide sound and independent stewardship when an independent board is not present.

Challenges and Trends

The following five areas were noted by survey respondents as emerging priorities for internal audit functions over the next three years:

- Risk Management Attestation
- IT
- Major Projects Implementation
- Fraud and
- Core Financial Controls

These priorities are largely consistent across all sectors and organisation sizes. As internal audit is increasingly expected to sign off on risk processes, risk management attestation has accordingly become a top priority. The economic downturn has also led to increased fraud risk as business cost-cutting curtails fraud prevention activities while the motivation to commit fraud has risen in step with personal financial pressures.

Quality

When asked whether their organisations' internal audit activity met quality benchmarks, 87% of respondents indicated they ensure quality through compliance with the *Standards*. However, on average only 42% revealed they were fully compliant and 50% were only partially compliant. Partial compliance may suggest that organisations are choosing to comply with the less demanding elements of the *Standards* rather than the more significant and challenging ones.

It is also noteworthy that government (49%) and not-for-profit organisations (44%) out-performed their private sector counterparts with respect to compliance with the *Standards*.

An effective way of ascertaining the level of compliance with the *Standards* is through subjecting the internal audit function to an External Quality Assessment as required in Standard 1310. Yet less than half (43%) of the respondents had undertaken this exercise in the last three years. This raises questions about the quality of work performed by some internal audit functions and may reflect the fact that some organisations are willing to undergo an external quality assessment where they are aware they do not fully comply with the *Standards*.

Internal Audit Resources and Competencies

Organisations identified a need for greater internal audit resources in three key areas:

- IT – 45%
- Risk Management – 33%
- Operations – 26%

In addition, respondents noted that their internal audit team would be more effective with enhanced competencies in:

- Continuous Auditing
- Data Analysis
- Marketing of the Internal Audit Function

These findings are consistent with those from a 2009 international internal audit study focussed predominantly on the United States, United Kingdom and Europe, where similar skillset requirements were identified:

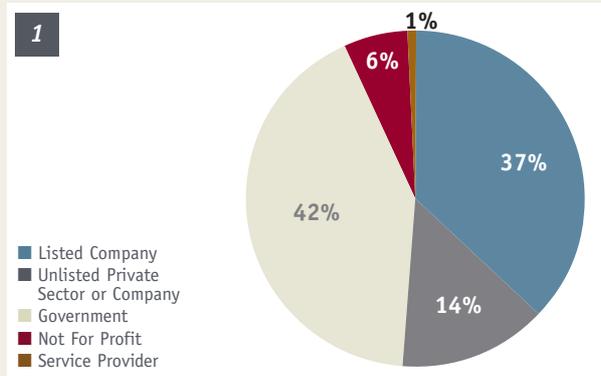
- Continuous Auditing and Computer Assisted Audit Techniques (CAATs)
- Data Analysis Tools
- Fraud Monitoring.



About this Study

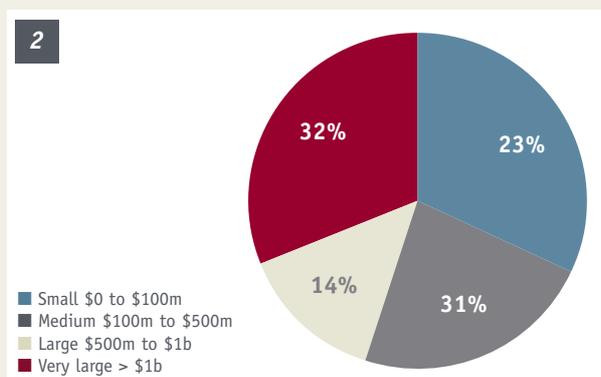
The study includes a diverse range of sectors and organisations. Participants invited to take part in the survey earlier this year were Chief Audit Executives (CAE) who are current members of the Institute of Internal Auditors-Australia (IIA).

Graphs 1-4: Organisational graphs



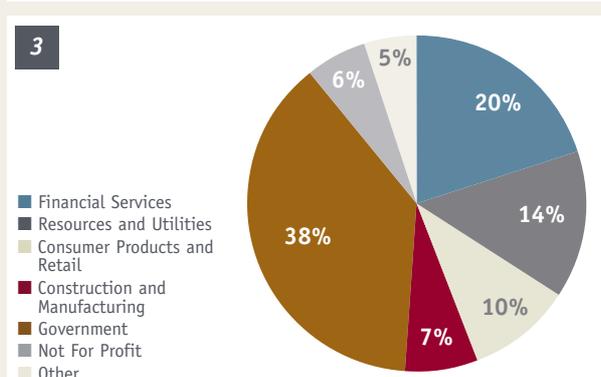
Organisations by type - Graph 1

- Data was collected from over 150 organisations.
- Participants in the survey included listed companies (37%), unlisted private companies (14%), federal, state and local government agencies (42%) and not-for-profit organisations (6%).



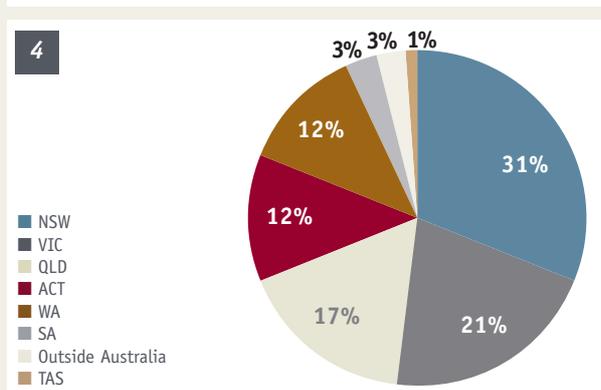
Organisations by size - Graph 2

- Small and medium organisations represented just over half of the respondents (54%).
- Almost one-third of respondents (32%) indicated revenues and/or budget exceeding AUD \$1 billion.



Organisations by industry - Graph 3

- The public sector represented the largest single sector taking part in the survey (38%).
- This was followed by the financial services (20%) and resources/utilities industries (14%).



Organisations by state - Graph 4

- Information was collected across each of the six states and the Australian Capital Territory.
- The highest proportion of respondents came from New South Wales (31%), followed by Victoria (21%) and Queensland (17%).
- A small proportion of respondents were resident outside Australia (3%).

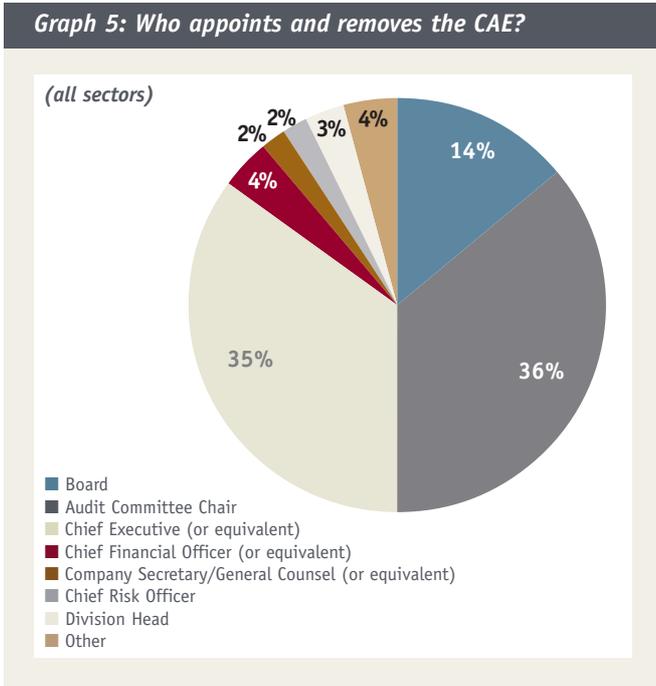


Authority, Independence and Mandate

Authority, Independence and Mandate

Internal audit's role in the governance process is optimised when the internal audit is independent from management and reports to individuals with no perceived motivation to limit the scope of internal audit activities. A direct reporting line to the audit committee is best practice. Yet, the study indicates that internal audit's functional independence is compromised by excessive influence from executive management on key matters such as appointments, performance evaluation, work scope and budgeting.

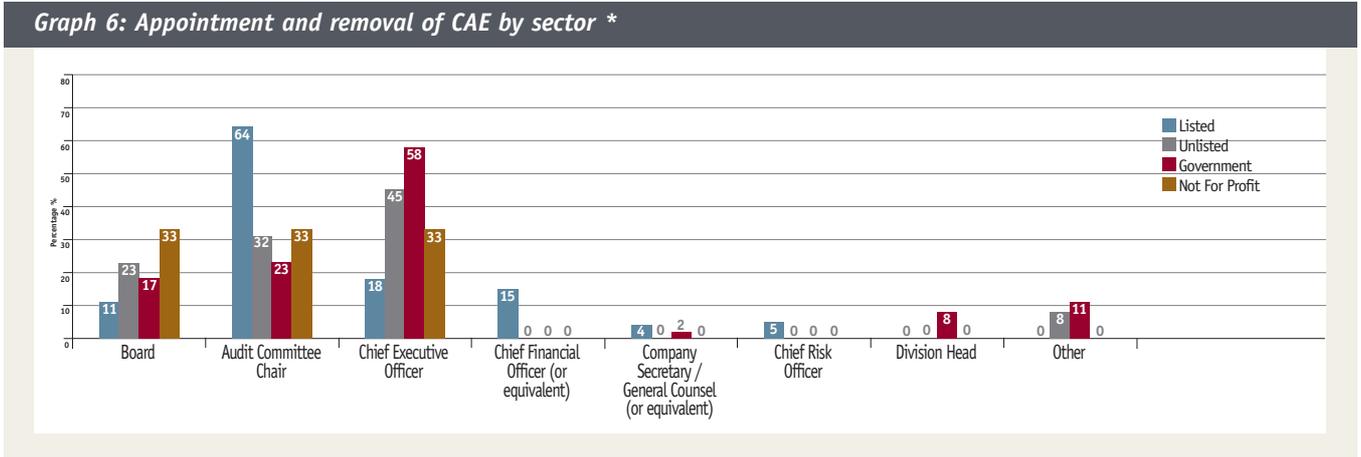
Graph 5: Who appoints and removes the CAE?



Appointment and removal of the Chief Audit Executive (CAE) – Graph 5 & 6

- In the majority of listed companies, the Audit Committee Chair is responsible for the appointment and removal of the CAE (64%).
- Of concern is the fact that in many listed companies, the Chief Financial Officer (CFO) is responsible for CAE appointments and removals (15%).
- In Government organisations, the Chief Executive equivalent bears this responsibility (58%).

Graph 6: Appointment and removal of CAE by sector *



* Percentages may exceed 100% as respondents provided more than one final decision-maker.

Authority, Independence and Mandate

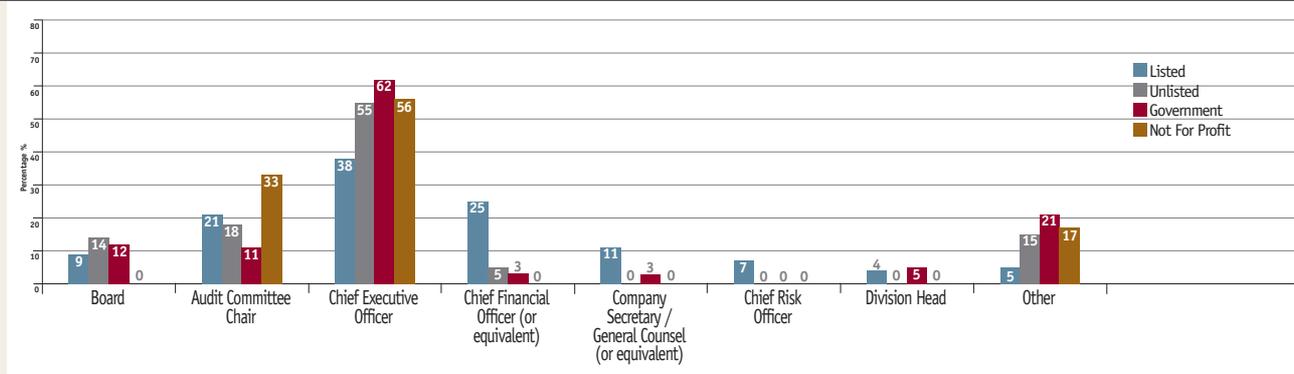
Setting the remuneration and bonus of the CAE – Graph 7

- The Chief Executive (or equivalent) is primarily responsible for setting the remuneration and bonus of the CAE across all sectors.
- In listed companies, one-quarter (25%) of CFOs perform this function, despite this being contrary to recommended practice.

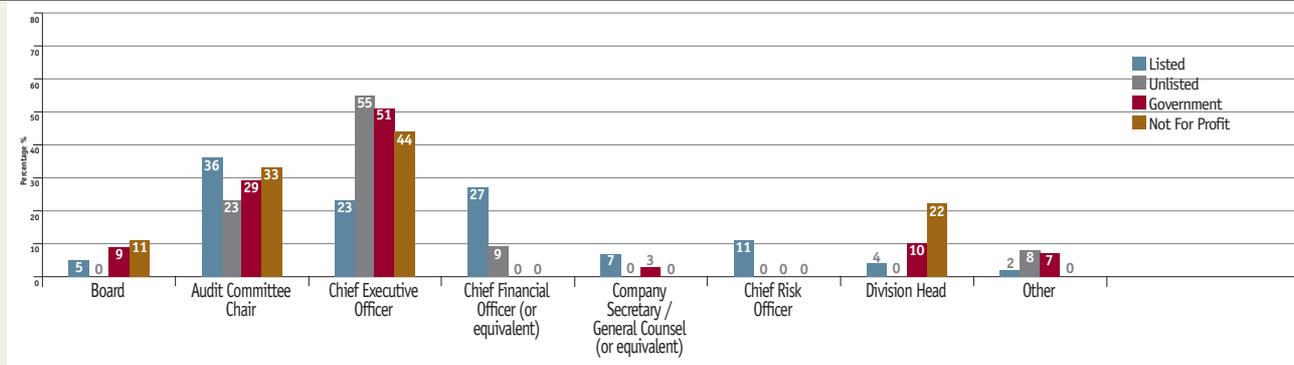
Evaluating the performance of the CAE – Graph 8

- The Chief Executive (or equivalent) and the Audit Committee are responsible for evaluating the performance of the CAE across all sectors.
- In listed companies, the CFO (27%) and the Chief Risk Officer (11%) are the final decision-makers regarding CAE performance, again contrary to recommended practice.

Graph 7: Setting the remuneration and bonus by sector *



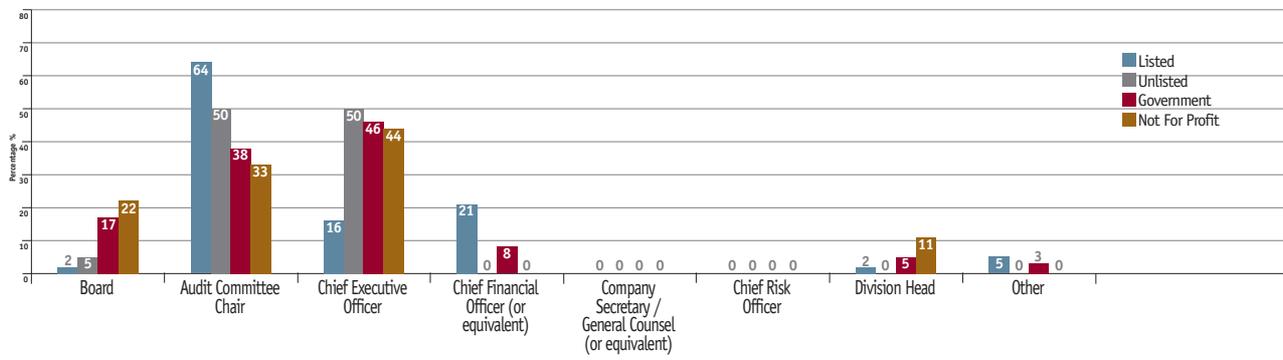
Graph 8: Evaluating performance of the CAE *



* Percentages may exceed 100% as respondents provided more than one final decision-maker.

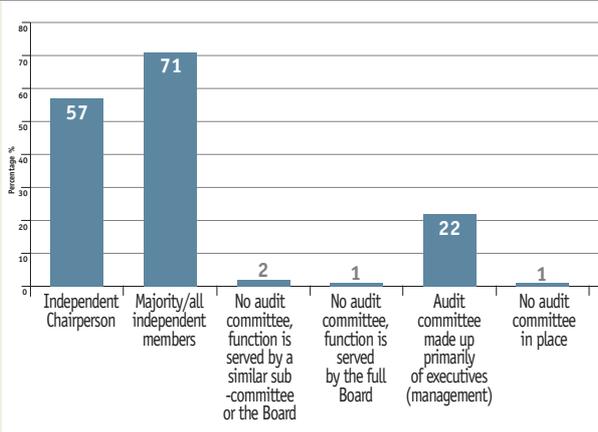
Authority, Independence and Mandate

Graph 9: Approving internal scope and budget *



* Percentages may exceed 100% as respondents provided more than one final decision-maker.

Graph 10: Composition of the audit committee



Approving the scope and budget of internal audit – Graph 9

- In almost two-thirds (64%) of listed companies, the Audit Committee approves the scope and budget of the internal audit function.
- 21% of CFOs in listed companies have this responsibility, again contrary to recommended practice.

Composition of the audit committee – Graph 10

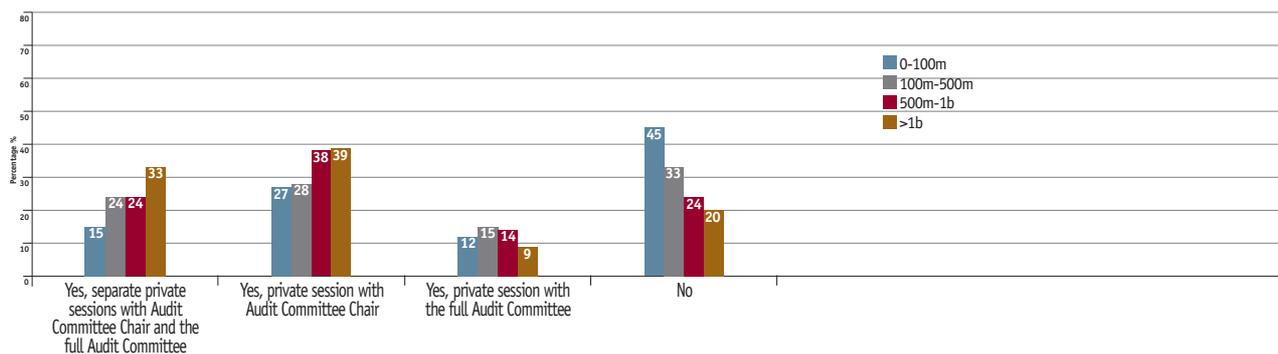
- Almost all of the organisations that responded to the study have an audit committee or equivalent body acting in that capacity, which is encouraging.
- However, almost one half (43%) reported that their audit committee does not have an independent chairperson. In addition, 22% stated that their audit committee consists largely of executive management.
- 20% of listed company audit committees do not have an independent chairperson, which is contrary to recommended practice.

Authority, Independence and Mandate

Private meetings without management – Graph 11

- The holding of private meetings between the CAE and Audit Committee without management present, is a critical element of an independent internal audit function.
- Almost one-third of CAEs (31%) do not hold private meetings with the audit committee. This is consistent throughout all sectors and across medium to large organisations.
- In almost half (45%) of smaller organisations with turnover less than \$100m, the CAE does not meet privately with the audit committee in the absence of management.

Graph 11: CAE meeting privately without management



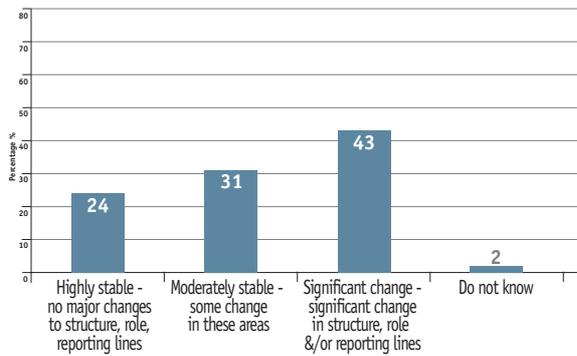


Challenges and Trends

Challenges and Trends

Internal audit is a long-standing but rapidly evolving profession, with increasing demands on the extent and scope of work performed. This poses challenges for the profession in meeting new expectations while not losing sight of traditional core areas.

Graph 12: Change in structure and direction of internal audit in last 3 years



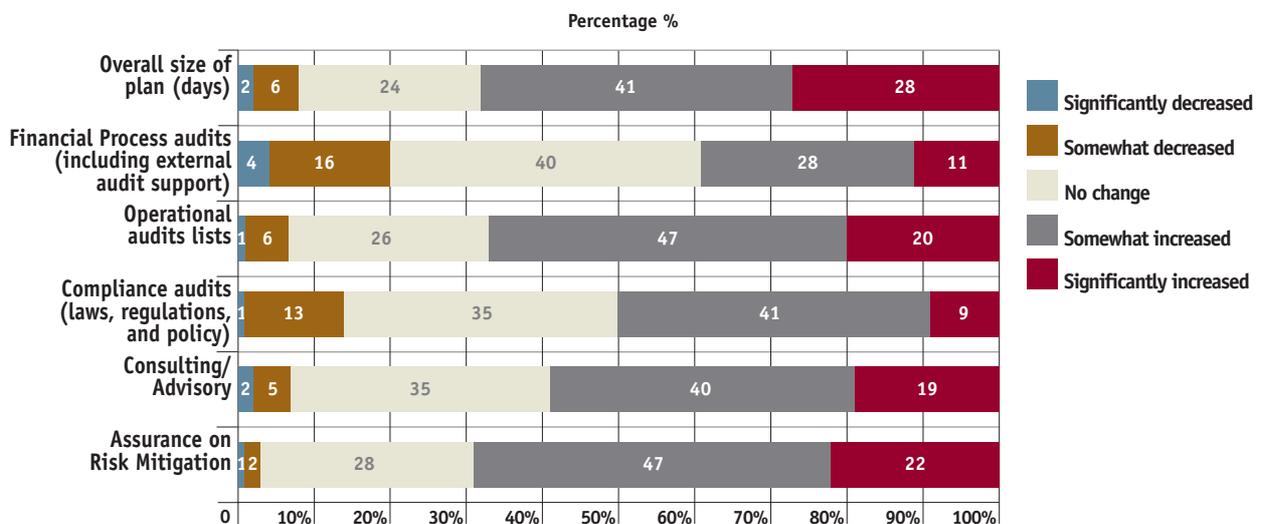
Change in structure and direction of internal audit in last 3 years – Graph 12

- The level of change in the structure and direction of the internal audit function was significant for almost half (43%) of Australian organisations.

Change in scope of internal audit in last 3 years – Graph 13

- Assurance on risk mitigation and operational audits were areas that saw an increase – 69% and 67% respectively.
- Financial process audits did not change in 40% of organisations.

Graph 13: Change in scope of internal audit in last 3 years

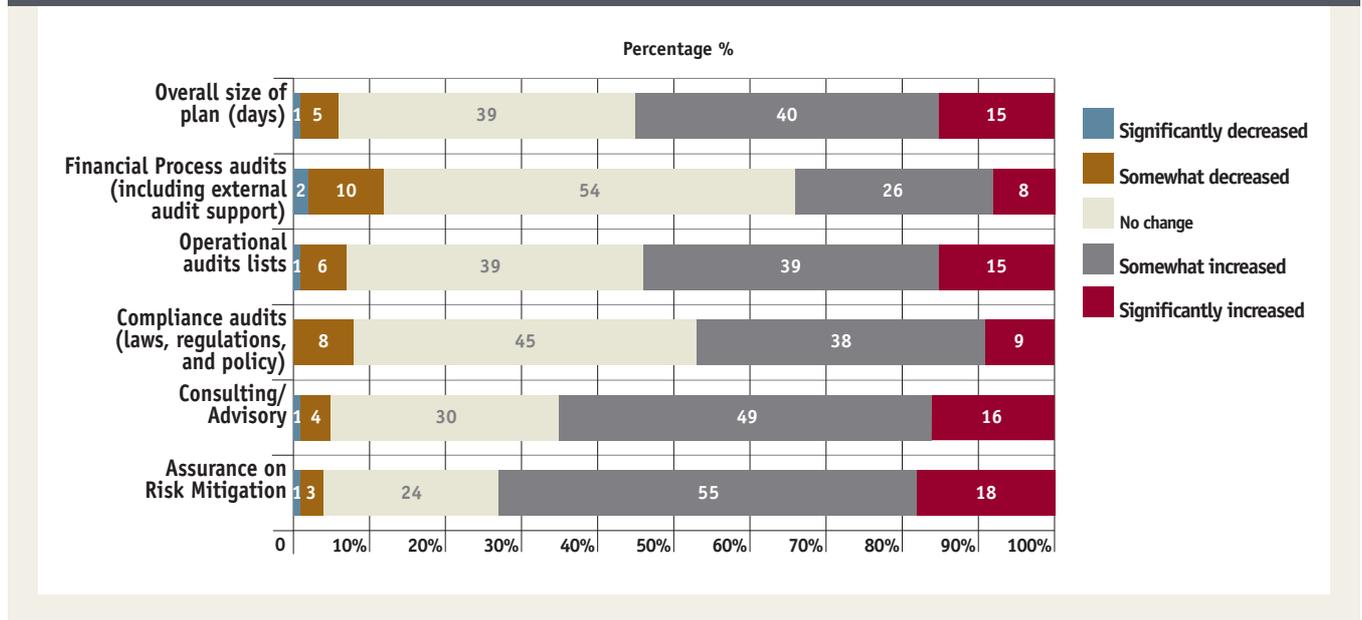


Challenges and Trends

Change in scope of internal audit in next 3 years – Graph 14

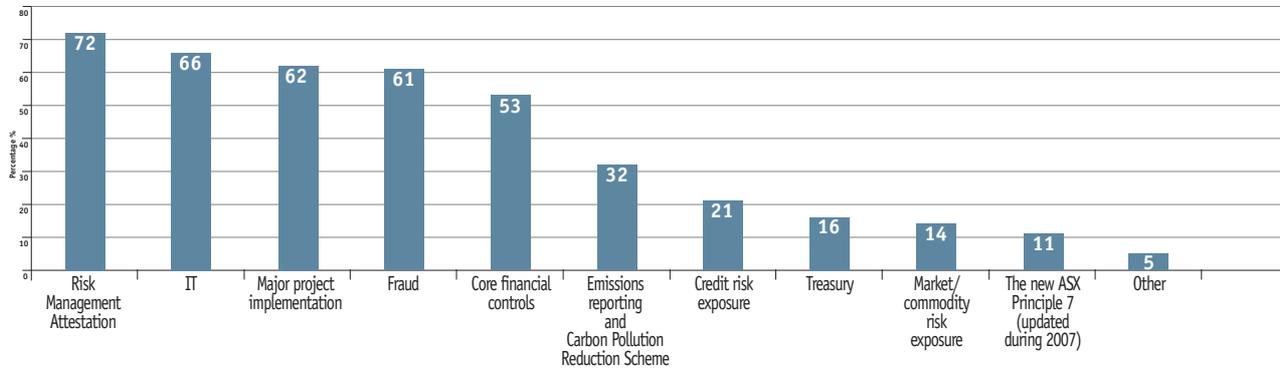
- Almost three-quarters of organisations (73%) expect that assurance on risk mitigation will increase over the next 3 years.
- Financial audits are likely to stay at the same levels for just over half or the organisations (54%).

Graph 14: Change in scope of internal audit in next 3 years

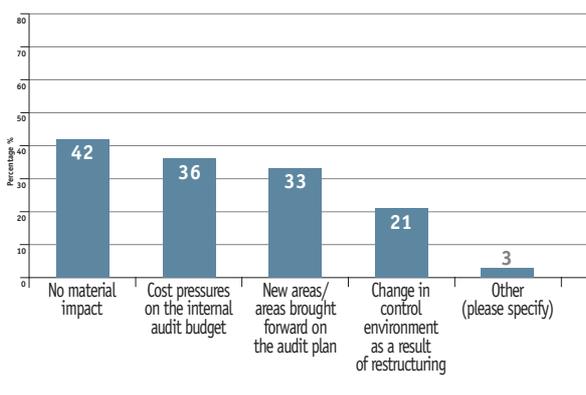


Challenges and Trends

Graph 15: Emerging priorities in next 3 years



Graph 16: Impact of the global financial crisis on internal audit activity



Emerging priorities for internal audit in the next 3 years – Graph 15

- The top five areas nominated as emerging priorities over the next 3 years are risk management attestation, IT, major project implementations, fraud and core financial controls.
- These priorities are consistent across all sectors and organisation size.

Impact of the Global Financial Crisis (GFC) on internal audit activity – Graph 16

- Almost half of organisations (42%) indicated that the GFC would have no material impact on their internal audit activity at the time of the survey.
- Over one-third (36%) stated that the internal audit budget would face cost pressures as a result of the GFC.
- More than half indicated significant additional demands, with 33% indicating their scope included new areas or areas brought forward and 21% indicating a change in control environment.

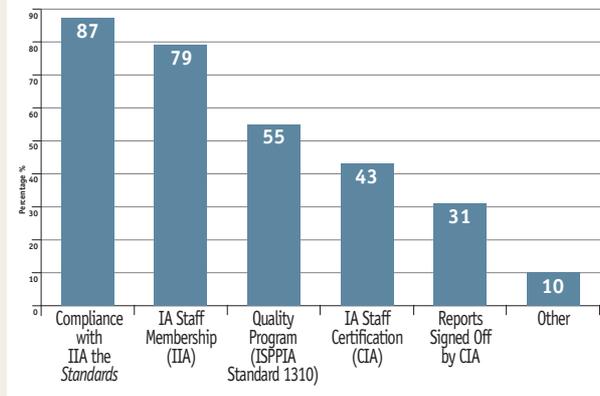


Quality

Quality

This section asked participants to indicate how they ensured quality and professionalism in their teams and functions. Surprisingly, despite seeing the importance of membership, certification, quality programs and compliance with the *Standards*, these requirements are still not universally applied.

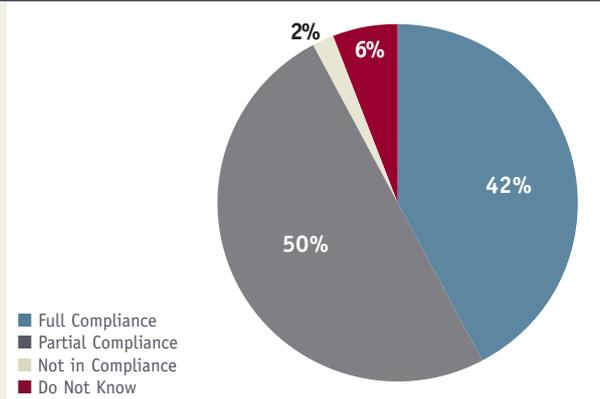
Graph 17: Ensuring quality in internal audit



Ensuring quality in internal audit – Graph 17

- Respondents in the majority of organisations revealed (87%) that the best way to ensure quality in their internal audit activity was to comply with the International Standards for the professional practice of Internal Audit (*Standards*).
- Internal audit team members were encouraged to be members of the IIA by almost 8 out of 10 organisations (79%).

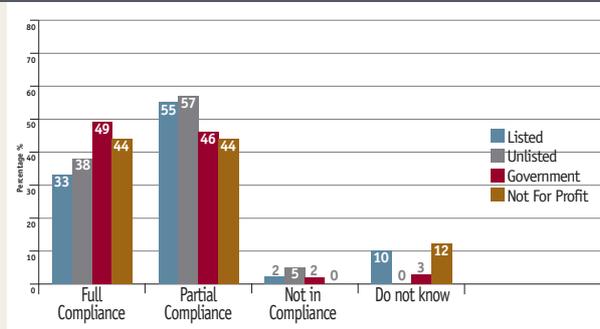
Graph 18: Level of compliance with the Standards



Level of compliance with the Standards – Graphs 18 & 19

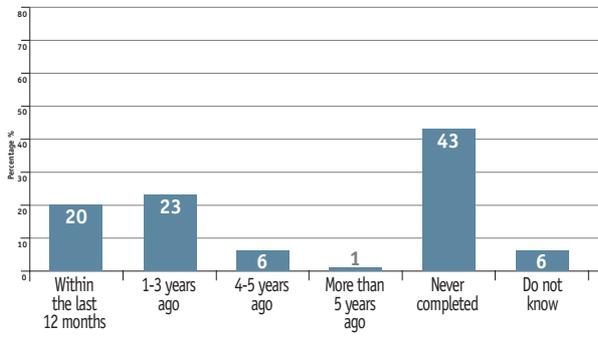
- Despite acknowledgement of the importance of adherence to the *Standards*, less than half (42%) of respondents indicated they fully complied with the *Standards*, with 50% indicating partial compliance, 2% not complying and 6% unsure.
- The level of compliance with the *Standards* was relatively consistent across all sectors and organisation size.
- The government and not for profit organisations indicated a higher level of full compliance (49% and 44%) than listed and unlisted companies (33% and 38%).

Graph 19: Level of compliance with the Standards by sector



Quality

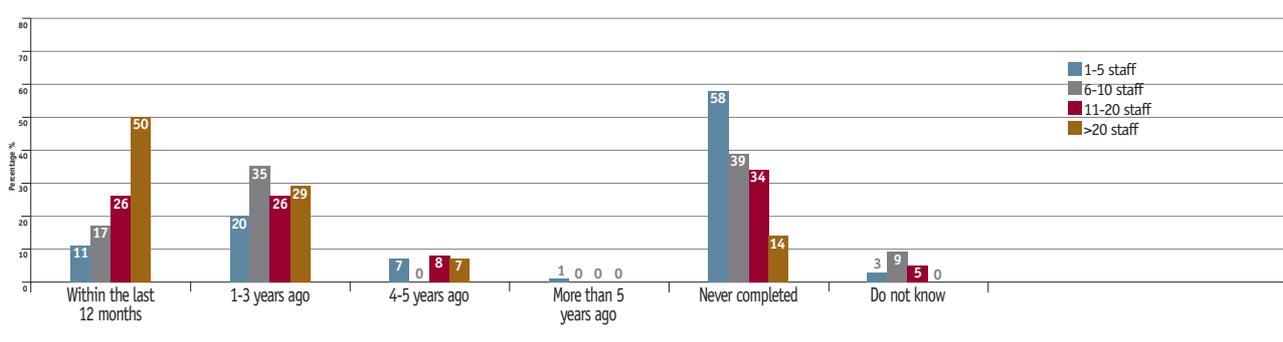
Graph 20: Last external quality assessment review



Last external quality assessment review – Graphs 20 & 21

- The *Standards* require quality assessment of the internal audit function at least every five years with internal quality processes to be performed on an ongoing basis.
- Less than half (43%) of respondents had undertaken an external quality assessment within the last 3 years.
- One-fifth had completed an assessment within the last 12 months.
- Organisations with less than five internal audit staff were less likely to have undertaken an external assessment.
- 43% of respondents had never completed an external quality assessment.

Graph 21: Last external quality assessment by number of staff in internal audit



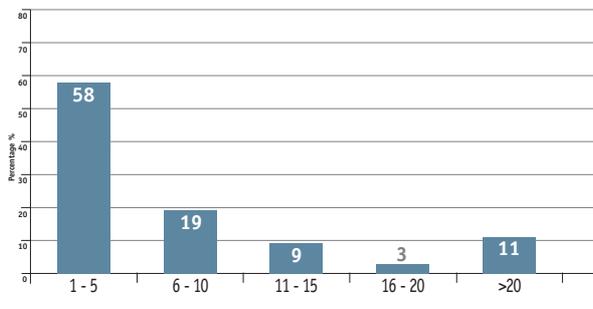


Internal Audit Resources and Competencies

Internal Audit Resources and Competencies

As internal audit's scope and remit continues to broaden, skills, resources and competencies need to evolve to keep pace. This section outlines key findings in this area.

Graph 22: Number of FTE personnel in internal audit



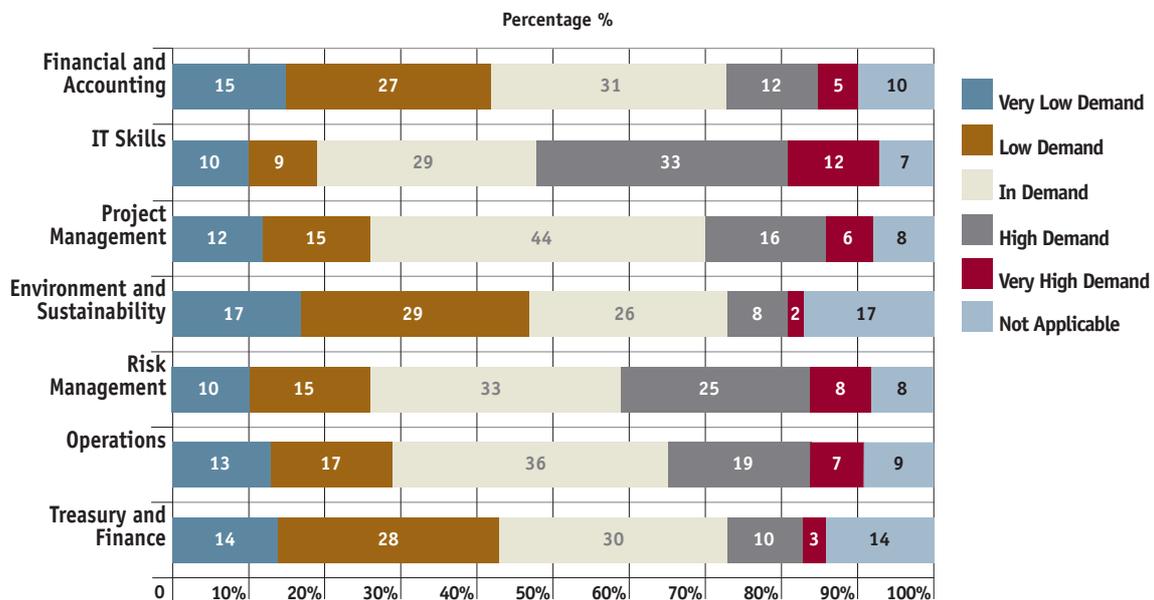
Number of full time equivalent (FTE) personnel in internal audit – Graph 22

- Almost 60% of organisations employed between one and five FTE staff in their internal audit department.
- The average number of full time internal audit employees in an in-house capacity was five and the average number of FTE personnel either in-house or external was seven.

Unfilled demand for key technical skills – Graph 23

- The top three technical skills in greatest demand were IT (45%), risk management (33%) and operations (26%).
- While financial and accounting skills are still in demand, this is now exceeded by demand for project management skills.

Graph 23: Unfilled demands for technical skills

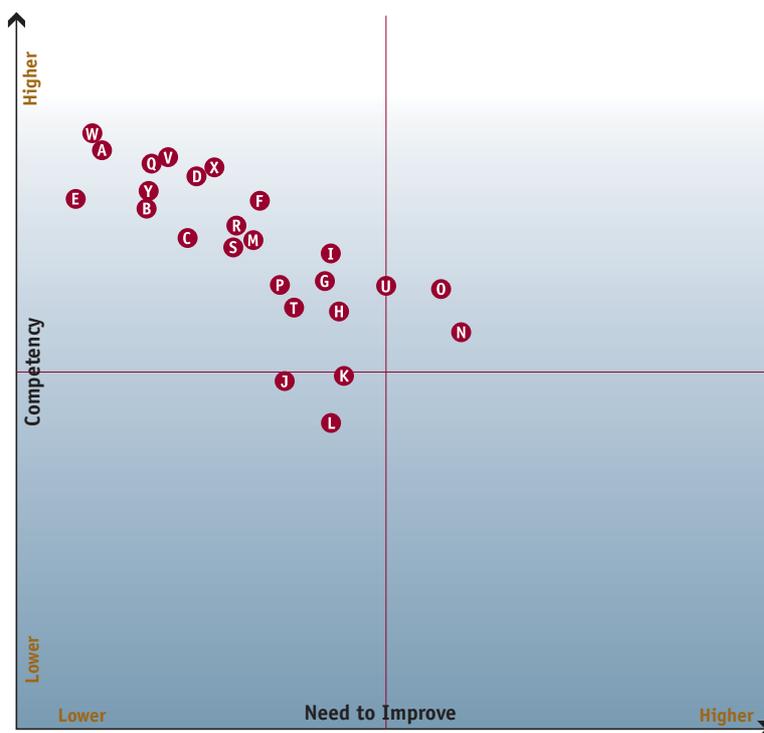


Internal Audit Resources and Competencies

Internal audit team competencies and areas for improvement – Graph 24

- Respondents were asked to assess, on a scale of one to five, their team’s competency in 25 areas of technical knowledge important to internal audit, with one being the lowest competency and five being the highest. They were then asked to indicate whether they believed their team possessed adequate competencies or if there was room for improvement, taking into account the circumstances of their organisation and industry.
- Respondents indicated that their teams would be more effective with enhanced competencies in 1) continuous auditing, 2) data analysis and 3) marketing of the internal audit function (top right quadrant).
- These findings are consistent with those from a 2009 international internal audit study focussed predominately on the United States, United Kingdom and Europe, where similar skill deficiencies were identified, namely continuous auditing, data analysis tools and fraud monitoring.

Graph 24: IA capabilities and needs



- A Financial Review
- B Compliance with Regulations
- C Compliance with ASX Principle 7
- D Operational Review
- E External Audit Assistance
- F Risk Management Assurance
- G Operational Efficiency
- H Revenue Enhancement
- I Fraud
- J Anti-Money Laundering
- K Culture Assessment
- L Mergers and Acquisitions
- M Governance Structuring
- N Continuous Audit
- O Data Analysis
- P Self Assessment Techniques
- Q Developing Recommendations
- R Internal Quality Assessment (ongoing)
- S Internal Quality Assessment (periodic)
- T External Quality Assessment
- U Marketing Internal Audit
- V Planning Audit Strategy
- W Presenting to Audit Committee
- X Report Writing
- Y Resource Management

Internal Audit Resources and Competencies

Needs to Improve Rank	Personal Skill & Capabilities	Competency (5 pt scale)
1	Developing outside contacts/networking	3.8
2	Leadership (within the IA profession)	3.4
3	Developing other Board Committee relationships	3.7
4	Time management	3.9
5	Strategic thinking	4.2

1 = Change Management

2 = Coaching/Mentoring

3 = Creating a learning IA function

4 = Developing Audit Committee relationships

5 = Developing other Board Committee relationships

6 = Developing rapport with senior executives

7 = Developing outside contacts/networking

8 = Leadership (within your organisation)

9 = Leadership (within the IA profession)

10 = Negotiation

11 = Personnel performance evaluation

12 = Presenting (small groups)

13 = Persuasion

14 = Strategic thinking

15 = Time management

16 = Written communication

Chief Audit Executive competencies and areas for improvement

- Respondents were asked to assess on a scale of one to five – with one being the lowest competency and five being the highest – their competency in 16 types of Personal Skills and Capabilities.
- They were then asked to indicate whether they believed their competency level was adequate or in need of improvement, taking into account the circumstances of their organisation and the nature of their industry. Listed on this page are the 16 Personal Skills and Capabilities.
- Developing outside contacts and networking was identified as the top area for improvement followed in second place by the need to improve leadership within the internal audit profession.
- The need to develop other Board Committee relationships was the third most important skill to improve. This is broadly comparable with the findings of the aforementioned 2009 international internal audit survey where developing relationships with other Board members has been the top priority for several years.
- Even though respondents reported relatively high competency levels in most of the top-ranked skills and capabilities, the findings nevertheless suggest that further improvement is essential as these areas remain key priorities.

Internal audit certification

Respondents were asked whether they were accredited as a Certified Internal Auditor (CIA). Almost half (48%) were not while 35% of respondents were CIA-certified. The remainder (17%) had intentions to become CIA qualified in the future.

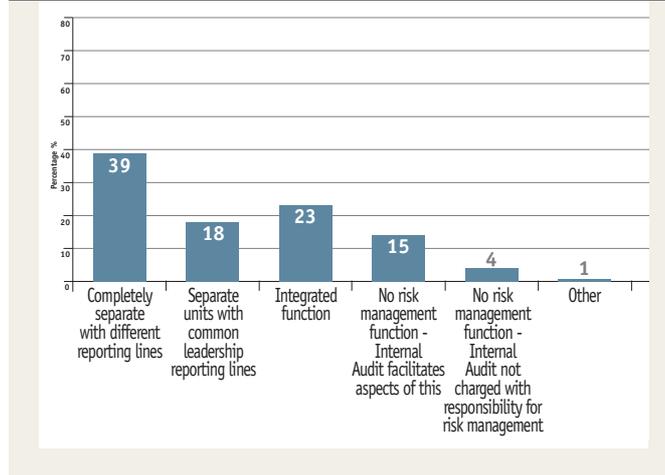


Enablers and Technology

Enablers and Technology

The efficiency of the internal audit function can be enhanced with the support of appropriate frameworks and technology solutions. This section outlines findings in this area.

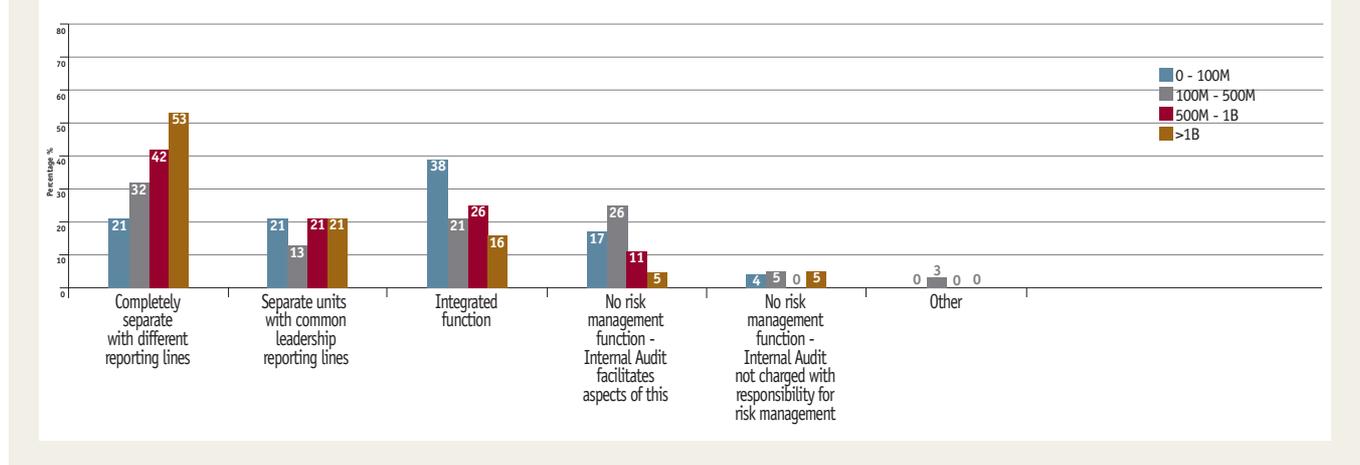
Graph 25: Relationship between the internal audit and risk management functions



Relationship between the Internal Audit and Risk Management functions – Graphs 25 and 26

- Almost one fifth (19%) of respondents indicated there was either no risk management function at all within their organisation or that internal audit was facilitating aspects of the risk management work.
- The larger the organisation, the greater the likelihood that risk management and internal audit would operate as separate functions with different reporting lines. Over half (53%) of companies with revenues over \$1 billion had completely separate internal audit and risk management functions with different reporting lines. By contrast, only 21% of organisations with revenues of less than \$100 million separated their risk management and internal audit functions.

Graph 26: Relationship between the internal audit and risk management functions



Enablers and Technology

Internal Audit methodology

- 42% of respondents used an in-house internal audit manual, while 31% used the IIA's methodology.
- 95% of respondents indicated that the internal audit plan was based on a formal risk identification and assessment undertaken within their organisation, as required by the *Standards*.

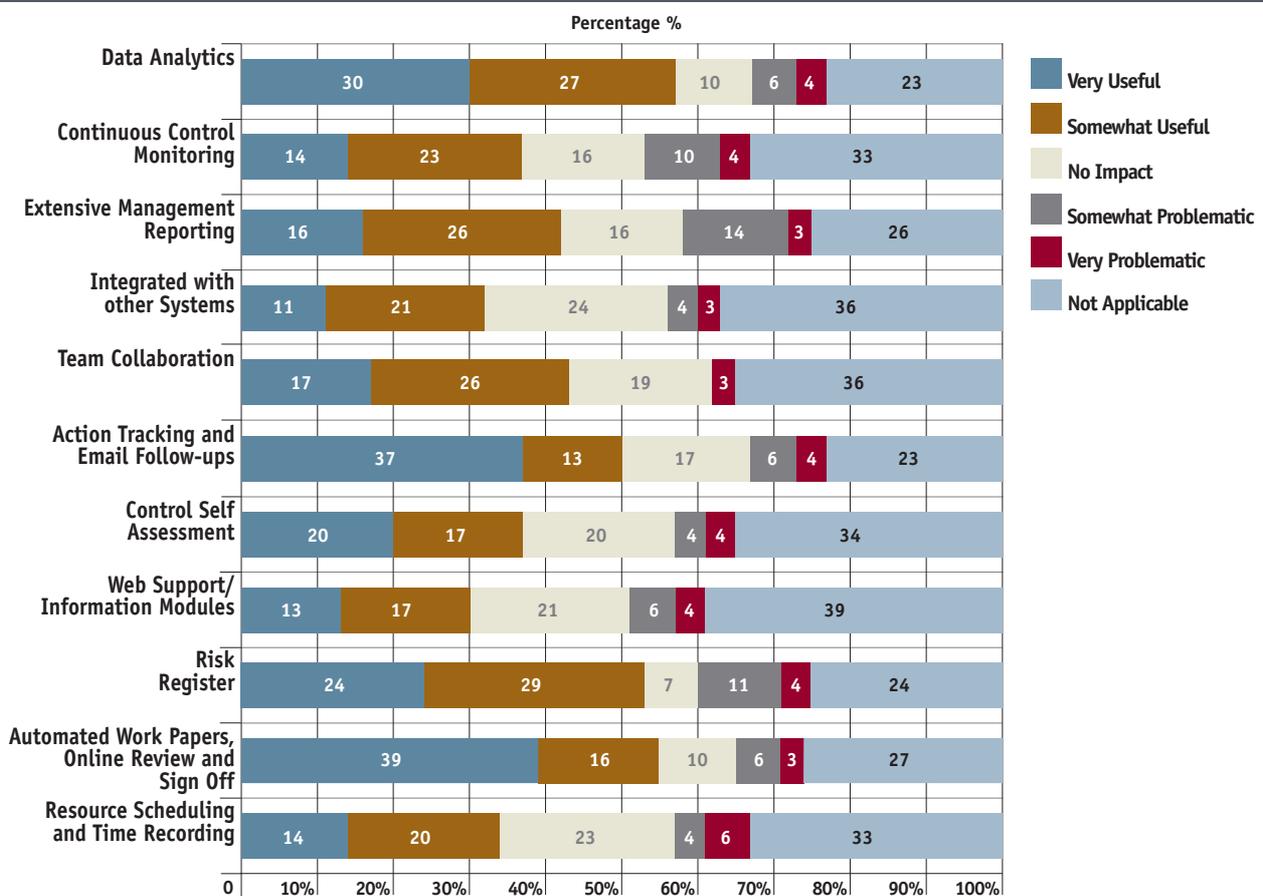
Computer assisted Audit Techniques (CAATs) and software tools

- Almost two-thirds (62%) used CAATs on an ad-hoc basis with limited use on specific projects.
- Over half (57%) indicated they used audit software tools and of those, the majority (75%) used 'off the shelf' tools.

Functionality provided by technology solutions – Graph 27

- Automated work papers, on-line review and sign-off were considered to be the most useful (39%) functionalities provided by the primary internal audit software tool. This was followed by action tracking (37%) and data analytics (30%).
- Resource scheduling and time recording were considered to be the most problematic functions (6%).

Graph 27: Functionality provided by the primary tool and its usefulness





Outcomes

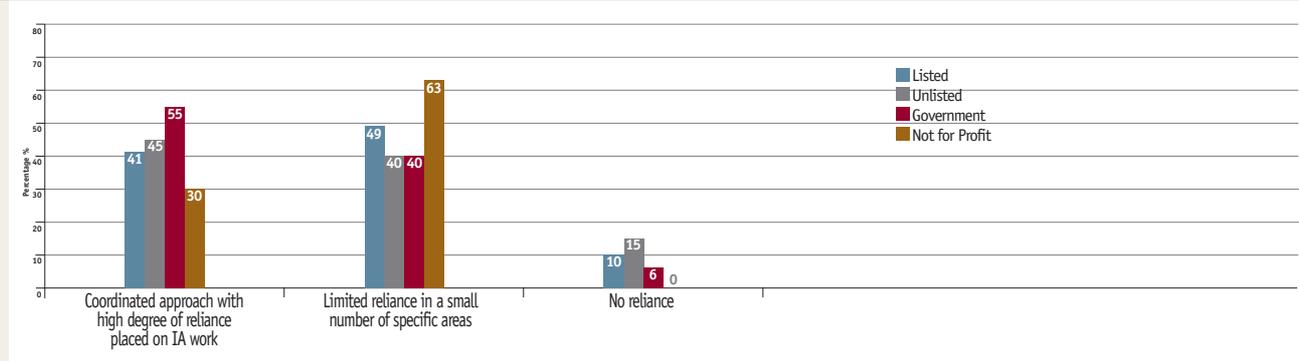
Outcomes

For the value of the internal audit function to be understood by the organisation, appropriate accountability frameworks must be in place for internal audit so that results are achieved and communicated in a transparent way. This section outlines key findings in this area.

Reliance by external auditor – Graph 28

- A coordinated approach between internal and external auditors prevents duplication of effort and presents a holistic assurance plan to the audit committee. It also enables greater reliance to be placed on internal audit work.
- Coordinated approaches were more common in the government sector (55%) where Federal and State Auditor Generals provided the external audit service themselves, or oversaw the outsourcing of the external audit to an appropriate audit provider.
- In one in ten listed companies and 15% of unlisted companies, the external auditor placed no reliance on the work of the internal audit team.

Graph 28: Extent of reliance by external auditor

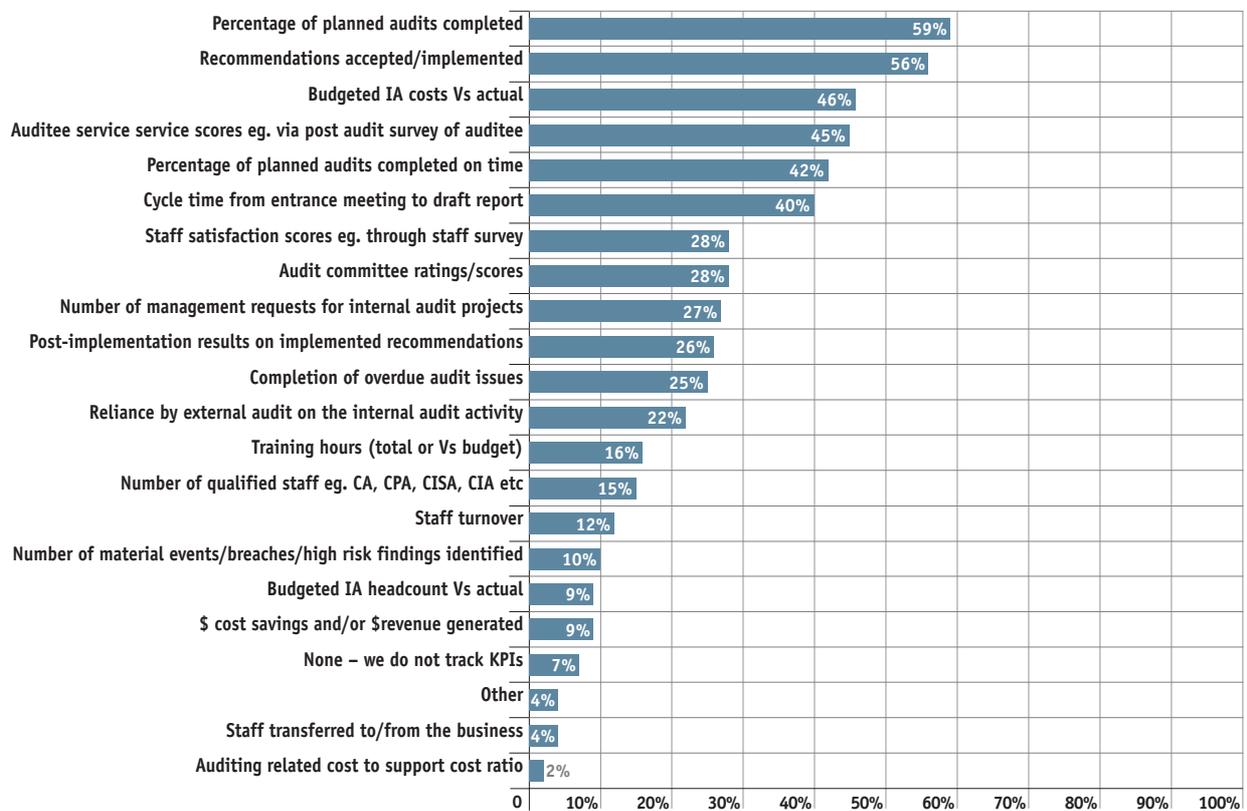


Outcomes

Key Performance Indicators (KPI) for internal audit – Graph 29

- A broad range of KPIs were used to measure the performance of Internal Audit.
- The percentage of audits completed was the most common KPI to measure internal audit performance (59%).
- Another key measure was recommendations accepted and implemented (56%).

Graph 29: KPIs used to measure internal audit performance



Outcomes

	Monitoring corrective action taken and resolution of audit issues/recommendations	Primary responsibility reporting status of audit issues/recommendations
Management	26%	11%
Internal Audit	32%	73%
Both	41%	16%
Other	1%	0%

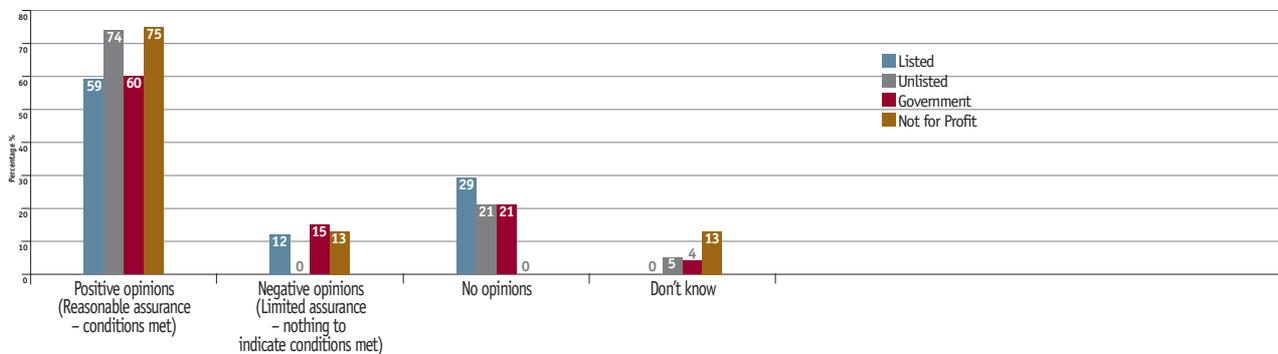
Reporting

- Accountability was mixed for monitoring corrective action – see table on left.
- Almost three-quarters (73%) of respondents indicated that internal audit has the primary responsibility for reporting the status of audit issues/recommendations.
- Over half (53%) used software such as spreadsheets or a database to track audit issues. One-fifth had a dedicated tracking system, while the same proportion used manual processes.
- Half of respondents indicated that Internal Audit used both issue rankings and report gradings to highlight significant findings from their review.
- Almost one quarter (23%) indicated that report formats and approaches had undergone major or substantial changes with the majority (60%) indicating moderate changes.

Providing assurance opinions – Graph 30

- Internal audit is increasingly being asked to provide audit opinions. Respondents reported that the majority of opinions provided were positive and capable of confirming reasonable assurance.
- Almost one-third of listed companies (29%) did not provide assurance opinions.

Graph 30: Providing assurance opinions



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