

## Policy Agenda

Institute of Internal Auditors – Australia



## About the Institute

The Institute of Internal Auditors - Australia (IIA) is the professional body representing Australian internal auditors. With more than 3,200 members in all states and territories across Australia our membership is made up of internal auditors in government, the corporate sector, and professional practice.

The IIA in Australia is the local affiliate of the global Institute of Internal Auditors (IIA Global) which represents more than 160,000 members in 165 countries around the world. IIA Global sets the global standards for internal audit which are internationally recognised as the authoritative source for internal audit practice.

The IIA runs the global Certified Internal Auditor® (CIA®) program which is internationally recognised as the gold standard in internal audit certification and is the only global member on COSO (Committee of Sponsoring Organisations of the Treadway Commission). COSO is comprised of five member organisations and is the recognised global standard setter in relation to internal control.

# Executive Summary

## Internal audit – a lynchpin of organisational governance

Internal audit is a key pillar of organisational governance. It is concerned with the adequacy of risk management and internal control systems, efficiency and effectiveness of operations, asset safeguarding and regulatory compliance. It provides an organisation's audit committee and executive management with an independent view on whether the organisation has an appropriate risk and internal control environment and acts as a catalyst for a strong risk and compliance culture within an organisation. Internal audit also plays an important role in helping non-executive directors understand what is happening in the organisations they are responsible for governing.

Internal audit is separate and distinct to the external auditor's role. The external auditor is required to provide an opinion on the statutory financial report to members. The external auditor's scope does not necessarily incorporate the aspects of the internal auditor's scope described above.<sup>1</sup>

In all sectors, internal audit can contribute to stronger organisations, more efficient and effective performance, better asset safeguarding and reduce the likelihood and severity of fraud and corruption.

In the corporate sector more effective risk management and internal control can also make a positive contribution to managing earnings volatility by helping to prevent unexpected market shocks. Reducing the number and severity of unexpected market surprises can in turn underpin market confidence and stability.

## The IIA's policy agenda

The IIA has five policy principles which are applicable to all organisations, irrespective of sector:

1. Internal audit is fundamental to good organisational governance
2. Public entities should have a strong and effective audit committee
3. Reporting lines for the head of internal audit should be appropriate
4. Organisations need clear accountability for risk management and internal control
5. Internal audit should operate at a consistently high standard

These principles and supporting recommendations are discussed on the pages that follow.

## Why is the IIA calling for action?

Despite best endeavours by regulators and directors, value destruction and reputational scandals continue to occur in all sectors. Fraud, corruption, misinformation, underperformance, asset write-downs and significant drops in share value continue to be a regular occurrence.

In Australia, despite widespread acceptance of the recommendations contained in this document, regulation and application of these recommendations is inconsistent. All sectors and jurisdictions in Australia lag in some respects, leading to unnecessary risks, underperformance, confusion and market inefficiencies.

Adoption of the IIA's policies allows for more effective self-regulation by all sectors and reduces the need for reactive or overly prescriptive legislation in the future. In turn, it also provides for stronger performance and effective risk management in all organisations and sectors.

Key issues and policy recommendations are summarised overleaf.

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1. For more information on the difference between the internal audit and the external audit professions, refer to the IIA's factsheet *An Auditor is an Auditor Right?* which is available from the IIA's website: [www.iaa.org.au](http://www.iaa.org.au).

## Key Principles and Recommendations

### 1. Internal audit is fundamental to good governance

- 1.1 Internal audit be required in all sectors (government, corporate, not-for-profit) where there is a separation of ownership and/or stewardship from management.
- 1.2 For the sake of clarity, legislative and regulatory references to 'the auditor' should be specific as to whether they are referring to external audit or internal audit.

### 2. Public entities should have a strong and effective audit committee

- 2.1 Audit committees should be required in all sectors where there is a separation of ownership and/or stewardship from management.
- 2.2 Audit committees for all sectors should have at least three members, the majority of which should be independent.
- 2.3 Audit committees should have an independent chair who is not also chair of the governing body. The committee should collectively have deep finance, accounting and audit experience.
- 2.4 Audit committee remuneration should be commensurate with audit committee workload, experience and personal exposure.

### 3. Reporting lines for the head of internal audit should be appropriate

Where an effective and appropriately structured audit committee is in place:

- 3.1 Hiring and firing of the head of internal audit should be a decision reserved by the governing body on recommendation by the audit committee.
- 3.2 Remuneration of the head of internal audit should be a decision reserved by the audit committee.
- 3.3 The scope and budget of internal audit should be a decision reserved by the audit committee on recommendation by the head of internal audit.
- 3.4 All internal audit work should be required to be reported to the audit committee and the audit committee should periodically request confirmation that all required reports have been tabled.
- 3.5 The audit committee chair should meet privately during the year with the head of internal audit. The audit committee should also meet at least annually with the head of internal audit without management present.

### 4. Organisations need clear accountability for risk management and internal control

- 4.1 All organisations should design and operate an effective system of risk management and internal control.
- 4.2 The governing body should require management to confirm at least annually:
  - whether they consider the organisation's risk management and internal control framework to be effective
  - that all foreseeable material risks have been reported to the governing body together with a true reflection of the status of these risks.
- 4.3 Internal audit should be asked to independently review and advise on the statements on risk management and internal control provided by management.
- 4.4 It is inappropriate for management to delegate primary responsibility to internal audit for the representations required under recommendation 4.2.

### 5. Internal audit should operate at a consistently high standard

- 5.1 The IIA's *International Standards for the Professional Practice of Internal Auditing (the Standards)* should be mandatory for anyone conducting internal audit work.
- 5.2 Anyone conducting internal audit work should be able to demonstrate compliance with *the Standards* in accordance with attribute standard 1312 of those standards.
- 5.3 Membership of the IIA should be recognised as the minimum requirement for all practicing internal auditors.
- 5.4 The head of internal audit and anyone issuing internal audit reports should be required to be IIA-certified.

## Principle 1

### Internal audit is fundamental to good governance

#### Recommendations

The IIA recommends that:

- 1.1 Internal audit be required in all sectors (government, corporate, not-for-profit) where there is a separation of ownership and/or stewardship from management.
- 1.2 For the sake of clarity, legislative and regulatory references to 'the auditor' should be specific as to whether they are referring to external audit or internal audit.

#### Key issues

- Well-run organisations in all sectors around the world have recognised the importance of internal audit and the contribution it makes to effective organisational governance and sustained long-term performance.

Organisations which have put internal audit in place without regulatory impetus cite a range of reasons including the desire for independent assurance on the adequacy of internal controls, independent assurance on the organisation's system of risk management and the desire for a more efficient and more effective organisation as a by-product of the internal audit process.

The need for this independent assurance is particularly pertinent when the span of control, size and complexity of the organisation increases. Rapidly changing enterprises also require assurance on the adequacy of their systems and processes as they respond and evolve. Given the rate of change experienced by most organisations today, most experienced directors would suggest that internal audit is a vital tool for fulfilling their duties as directors.

- Regulators around the world increasingly recognise that internal audit is an essential part of sound organisational governance. This has resulted in a trend towards mandating internal audit in all jurisdictions and sectors globally:
  - Internal audit is mandatory for listed companies around the world ranging from those on the NYSE in the United States to the KLSE in Malaysia.
  - Prudential regulators around the world require deposit-taking institutions to have an internal audit function.
  - Globally, governments are increasingly requiring all departments and agencies at all levels to have an internal audit function.

This trend is consistent across all sectors in all jurisdictions in Australia and internationally. There are no exceptions.

- While many studies demonstrate that there is a valuation premium for organisations with good corporate governance, in Australia we are also seeing that absence of strong corporate governance can result in increased share price volatility and a discount to net tangible assets, undermining returns to shareholders. Increasingly there is consensus that strong internal audit is one predictor of superior long-term performance of an organisation.

Internal audit is a cost effective method to prevent fraud and corruption. Conversely the absence of a strong internal audit function can be indicative of high risk in this area.

- Irrespective of the acknowledged need for internal audit, many listed companies do not have an internal audit function. Internal audit is noticeably absent in new entrants and those which have recently achieved significant market capitalisation, but is also absent in long-standing companies.

In government, internal audit is noticeably absent in some jurisdictions. In local government for example internal audit is neither mandated nor mature in some states and territories. This is also the case in the not-for-profit sector.

- Internal audit is the only activity in an organisation with the scope, remit and independence to give a view which is independent from management. Its focus on governance, risk and control also acts as a strong catalyst for change when change is required.

## Principle 2

### Public entities should have a strong and effective audit committee

#### Recommendations

The IIA recommends that:

- 2.1 Audit committees should be required in all sectors where there is a separation of ownership and/or stewardship from management.
- 2.2 Audit committees for all sectors should have at least three members, the majority of which should be independent.
- 2.3 Audit committees should have an independent chair who is not also chair of the governing body. The committee should collectively have deep finance, accounting and audit experience.
- 2.4 Audit committee remuneration should be commensurate with audit committee workload, experience and personal exposure.

#### Key issues

- Internal audit draws its organisational independence from the audit committee. As such internal audit requires audit committees to be effective as a platform for its own effectiveness.
- The need for independent audit committees is now well understood. However the use and composition of audit committees is highly variable in all sectors. In order to be effective audit committees must be independent of management and have appropriate skills and composition.<sup>2</sup>
- In many organisations the remuneration for audit committee members is not in line with the workload, experience or personal exposure of the role. This causes difficulty in constituting appropriate and effective audit committees, which in turn undermines the independence and effectiveness of internal audit.
- There is a strong correlation between the strength of the audit committee and the level of performance by internal audit. As such internal audit has a strong interest in having a strong audit committee to oversee and direct the internal audit activity.

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2. For authoritative guidance refer to *Audit Committees: A Guide to Good Practice* issued by AICD, AUASB and the IIA, February 2008.

## Principle 3

### Reporting lines for the head of internal audit should be appropriate

#### Recommendations

The IIA recommends that where an effective and appropriately structured audit committee is in place:

- 3.1 Hiring and firing of the head of internal audit should be a decision reserved by the governing body on recommendation by the audit committee.
- 3.2 Remuneration of the head of internal audit should be a decision reserved by the audit committee.
- 3.3 The scope and budget of internal audit should be a decision reserved by the audit committee on recommendation by the head of internal audit.
- 3.4 All internal audit work should be required to be reported to the audit committee and the audit committee should periodically request confirmation that all required reports have been tabled.
- 3.5 The audit committee chair should meet privately during the year with the head of internal audit. The audit committee should also meet at least annually with the head of internal audit without management present.

#### Key issues

- Internal audit must be structurally independent and free from coercion by management to be effective in its role.
- Functional reporting to an appropriately constituted audit committee on key issues ensures that the head of internal audit is able to report objectively without fear or favour and to know that action will be taken by the governing body if required.

Not having these safeguards means that the organisation's head of internal audit could be removed, placed under duress, censored or have their scope and resources reduced by a whim of management. Such behaviours are a common theme in corporate collapses and organisational scandals, and continue to occur today where these safeguards are not in place.

- There is a symbiotic relationship between the audit committee and internal audit. A strong working relationship with the audit committee is vital to internal audit performing its role. It also allows the audit committee to drive internal audit to meet its expectations.
- Notwithstanding these safeguards internal audit will be expected to have a close relationship with and administrative reporting to senior management (usually the chief executive or equivalent).



## Principle 4

### Organisations need clear accountability for risk management and internal control

#### Recommendations

The IIA recommends that:

- 4.1 All organisations should design and operate an effective system of risk management and internal control.
- 4.2 The governing body should require management to confirm at least annually:
  - whether they consider the organisation's risk management and internal control framework to be effective
  - that all foreseeable material risks have been reported to the governing body together with a true reflection of the status of these risks.
- 4.3 Internal audit should be asked to independently review and advise on the statements on risk management and internal control provided by management.
- 4.4 It is inappropriate for management to delegate primary responsibility to internal audit for the representations required under recommendation 4.2.

#### Key issues

- Risk management and internal control are a fundamental part of good management and governance, but too often are secondary considerations relative to short-term performance.
- The maturity and scope of risk management and internal control frameworks is highly variable. Approaches to risk management and internal control continue to evolve, but are still inconsistent across and within sectors.
- The absence of clear accountabilities for risk management and internal control can lead to this area not being given the priority it deserves. There have been too many examples of this in recent times, and where calls for greater focus have fallen on deaf ears.
- The absence of thorough review of these areas by an independent party can mean that undue reliance may be placed on the organisation's risk and control frameworks. Internal audit is best placed to undertake this review.
- While organisations may look to internal audit for advice and assurance on the risk management framework and system of internal control, accountability for design and operation of these should remain with management (not internal audit).

## Principle 5

### Internal audit should operate at a consistently high standard

#### Recommendations

The IIA recommends that:

- 5.1 The IIA's *International Standards for the Professional Practice of Internal Auditing (the Standards)* should be mandatory for anyone conducting internal audit work.
- 5.2 Anyone conducting internal audit work should be able to demonstrate compliance with *the Standards* in accordance with attribute standard 1312 of those standards.
- 5.3 Membership of the IIA should be recognised as the minimum requirement for practicing internal auditors.
- 5.4 The chief audit executive and anyone issuing internal audit reports should be required to be IIA-certified.

#### Background

The IIA is the only professional body dedicated to the advancement of the internal audit profession. It runs an extensive range of programs to ensure that IIA members operate and are able to operate at the highest standards.

- The IIA's *International Standards for the Professional Practice of Internal Auditing (the Standards)* set the minimum standards for internal auditors world-wide. All IIA members are required to comply with *the Standards* under the IIA's by-laws.
- *The Standards* require all internal audit functions to demonstrate compliance with *the Standards* through a quality program with independent validation at least every five years.<sup>3</sup>
- The international qualification for internal audit is the Certified Internal Auditor®. The IIA also offers specialist certifications: Certified Government Auditing Professional™ (CGAP™), Certified Financial Services Auditor™ (CFSATM), and Certification in Control Self-Assessment™ (CCSATM). These certifications ensure a base level of competence required to perform and sign off on internal audit work.

#### Key issues

- Unlike registrations for external auditors, there is no requirement for certification or registration by those signing off on internal audit reports.
- Individuals and firms are able to hold themselves out as providing internal audit work without being a member of the IIA, attending relevant training, complying with *the Standards*, or being IIA-certified.
- A deep global body of knowledge exists for internal audit within the internal audit profession, yet standard setters, government departments and external auditors continue to develop their own guidance which conflicts with best practice and some of IIA's policy guidance.
- Despite significant improvements in these areas, there are still some disturbing trends. Recent research indicates:
  - Despite almost universal acceptance that internal auditors should use *the Standards*, many indicate that they only partially comply or do not comply at all.
  - Less than 50% are able to demonstrate compliance with *the Standards* through external certification.
  - A significant proportion of heads of internal audit are not IIA-certified.
  - A smaller but still significant minority are not members of the IIA.

All of these factors contribute to variability in the quality and comprehensiveness of internal audit work.

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3. Standard 1312 states that external assessments must be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organisation.





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