

30 January 2006

Ms Merran Kelsall
The Chairman
Auditing and Assurance Standards Board
PO Box 204
Collins Street West
Melbourne VIC 8007

Dear Ms Kelsall

The Institute of Internal Auditors–Australia (IIA-Australia) appreciates the opportunity to offer comments on the AUASB exposure draft of the proposed re-issuing of Auditing Standard AUS 604 “*Considering the Work of Internal Audit*”.

Our commentary covers those matters in the exposure draft that relate to internal audit and its relationship with the work of external audit.

In particular, we make comment and recommendations on:

1. Chief audit executive (what we believe the head of an internal audit activity should be called, and their qualifications);
2. Definition of internal auditing;
3. Scope and objectives of internal audit;
4. Relationship between internal audit and external audit;
5. External audit reliance on the work of internal audit and its benefits;
6. Understanding and preliminary assessment of internal audit;
7. Timing of Liaison and Coordination;
8. Evaluating the work of internal audit; and
9. Appendix 1: Internal audit – understanding and preliminary assessment questionnaire.

Where we refer to *chief audit executive* throughout our submission, this means the head of internal audit and is the terminology recommended by The Institute of Internal Auditors. We recommend this term be used in the re-issued version of AUS 604.

We would also encourage use of the term *internal audit* rather than “internal auditing” throughout AUS 604 as *internal audit* is more widely used these days. We recommend this term be used in the re-issued version of AUS 604.

The IIA-Australia has 2,400+ members across all states and territories. Our members are in a diverse range of fields from the 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 110,000 members in internal audit, corporate governance, internal control, information technology audit, education and security.

Internationally the Institute has members in more than 160 countries and territories and is the acknowledged leader in standards, certification, education, research and technology guidance for the internal audit profession. The Institute has a *Code of Ethics* and *The International Standards for the Professional Practice of Internal Auditing*.

For your information and reference, we have included a copy of *The International Standards for the Professional Practice of Internal Auditing*, which may be a useful reference when preparing the final version of AUS 604.

Thank you for the opportunity to comment on the exposure draft. If you wish to discuss the matters raised below in any further detail please contact me on 02 9267 9155.

Yours sincerely

A handwritten signature in black ink, appearing to read 'C. McRostie', with a long horizontal stroke extending to the right.

Christopher McRostie
Chief Executive Officer
Institute of Internal Auditors – Australia

Attachment

Comment on the AUASB exposure draft of the proposed re-issuing of Auditing Standard AUS 604 “*Considering the Work of Internal Audit*”

Enclosure

The International Standards for the Professional Practice of Internal Auditing

The Institute of Internal Auditors-Australia
Comment on the AUASB exposure draft
of the proposed re-issuing of Auditing Standard AUS 604
“Considering the Work of Internal Audit”

1. Chief Audit Executive

The Head of an Internal Audit Activity

The International Standards for the Professional Practice of Internal Auditing issued by The Institute of Internal Auditors use the term *chief audit executive* when describing the “head of internal audit”.

Recommendation 1:

We recommend the term *chief audit executive* be used in AUS 604 when describing the “head of internal audit”.

Qualifications of a Chief Audit Executive

In order to determine whether the person heading an internal audit activity is qualified for the role, we believe the person must be a Certified Internal Auditor (CIA). The CIA qualification is globally recognised as representing competence in the principles and practices of internal audit.

To obtain the CIA qualification a candidate must:

- Hold a bachelor’s degree or its equivalent from an accredited university level institution;
- Be a person of high moral and professional character;
- Have a minimum of 24 months of internal audit experience or its equivalent; and
- Successfully complete a rigorous four-part examination with each part requiring a 75% pass mark.

The CIA examination tests a candidate’s knowledge and ability of current practices in internal audit, with the four parts of the examination covering:

1. The internal audit activity’s role in governance, risk and control;
2. Conducting the internal audit engagement;
3. Business analysis and information technology; and
4. Business management skills.

We believe achievement of the CIA qualification demonstrates the chief audit executive is committed to, and has a thorough understanding of, the role and requirements of an internal audit activity.

Recommendation 2:

We recommend AUS 604 incorporate reference to “Certified Internal Auditor” as a requirement for a chief audit executive (refer Appendix 1 comments below).

2. Definition of Internal Auditing

We note the exposure draft features a “definition” of internal auditing at paragraph 6. Unfortunately this is a dated version and does not accurately reflect the most recent definition of internal auditing contained in *The International Standards for the Professional Practice of Internal Auditing* issued by The Institute of Internal Auditors in 2001, which is:

“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.”

In addition, the use of the term “monitoring” in the exposure draft relates more to the responsibilities of management rather than the responsibilities of internal audit. In our opinion, management has primary responsibility for “monitoring” the operation of internal controls. The role of internal audit is associated with the evaluation of adequacy of risk management, controls and governance processes. The term “monitoring” of internal control as applied to internal audit is used on a number of occasions throughout the exposure draft.

Recommendation 3:

We recommend the definition of internal auditing in AUS 604 reflect the definition included in *The International Standards for the Professional Practice of Internal Auditing* issued by The Institute of Internal Auditors.

3. Scope and Objectives of Internal Audit

We note paragraph 8 of the exposure draft contains scope and objectives for internal audit which are control-oriented and do not include risk management and governance (refer the definition of internal auditing above). In its guidance to the internal audit profession, The Institute of Internal Auditors suggests the scope and objectives of an internal audit activity within an organisation should be:

“The scope of work of the internal audit activity is to determine whether the organisation's network of risk management, control and governance

processes, as designed and represented by management, is adequate and functioning in a manner to ensure:

- *Risk are appropriately identified and managed.*
- *Interaction with the various governance groups occurs as needed.*
- *Significant financial, managerial, and operating information is accurate, reliable, and timely.*
- *Employee's actions are in compliance with policies, standards, procedures, and applicable laws and regulations.*
- *Resources are acquired economically, used efficiently, and adequately protected.*
- *Programs, plans, and objectives are achieved.*
- *Quality and continuous improvement are fostered in the organisation's control process.*
- *Significant legislative or regulatory issues impacting the organisation are recognised and addressed properly.*

Opportunities for improving management control, profitability, and the organisation's image may be identified during audits. They will be communicated to the appropriate level of management."

Recommendation 4:

We recommend the scope and objectives of internal auditing in AUS 604 reflect those suggested by The Institute of Internal Auditors (refer above).

4. Relationship Between Internal Audit and External Audit

This section is rather brief and does not really cover the relationship between external audit and internal audit. Rather, it attempts to explain the role of each rather than focusing on their relationship and how they interact. For example, paragraph 10 states "...certain aspects of internal auditing may be useful in determining the nature, timing and extent of external auditing procedures", however there is nothing in this section to define this statement.

Expansion of this section could be achieved by either linking to the next section (refer additional new section suggested below "External Audit Reliance on the Work of Internal Audit and its Benefits"), or incorporating our proposed comments below in this section.

We also suggest a new additional paragraph 9 detailing the relationship between internal audit and external audit:

“Duplication of audit work between internal audit and external audit should be minimised through co-operatively working together.”

Recommendation 5:

We recommend the relationship between internal audit and external audit focus on their relationship and how they interact, rather than explaining the role of each.

We recommend the following paragraph be included:

“Duplication of audit work between internal audit and external audit should be minimised through co-operatively working together.”

5. External Audit Reliance on the Work of Internal Audit and its Benefits

We believe there would be additional value in adding a new section (or adding to the above section “Relationship Between Internal Audit and External Audit”) so as to appropriately introduce the benefits of reliance on the work of internal audit, with the benefits including:

- Potentially reducing the level of testing of controls and substantive testing performed by external audit; and
- Identifying potential areas of likely misstatement through review of the work performed by internal audit.

This revised section should incorporate the wording in paragraph 12 and paragraph 13, but it should be noted that these paragraphs in isolation do not provide sufficient information in any clarity to introduce the benefits of external audit reliance on the work of internal audit.

This section should also lead into the following sections by making reference that it is necessary to both assess the adequacy of the internal audit activity and then perform a separate assessment of the quality of work undertaken by internal audit.

Recommendation 6:

We recommend a new section be included in AUS 604 detailing the external audit reliance on the work of internal audit and its benefits.

6. Understanding and Preliminary Assessment of Internal Audit

Preliminary Assessment

This section could be explained more clearly. It is important AUS 604 clearly articulates why a preliminary assessment of internal audit is performed and the benefits to be realised in doing this. In our view there are two distinct reasons why a preliminary assessment is performed and AUS 604 should ideally cover the following:

- *“To assist with the identification and assessment of potential risks which may impact on the financial statements.”* Thus the work of internal audit may provide information relating to financial reporting risk that the external auditor may use to modify their own risk assessment, and the design and performance of further audit procedures; and
- *“To form an initial view as to the adequacy of the internal audit activity as a basis for potential reliance on the work performed by internal audit.”* This focuses on organisational and structural issues related to internal audit as outlined in paragraph 16 (a) – (d). An assessment that the internal audit activity is well organised and resourced; is objective; is technically competent; has an appropriate scope of financial reporting matters; and is organised such that work is undertaken with due professional skill and care – will impact on a decision to place reliance on the work performed by internal audit.

Paragraph 16 could include sub-paragraphs:

- *“Audit methodology employed: The nature and extent of the methodology employed by internal audit in the performance of its role. Consideration should be given to such factors as whether internal audit utilises a risk-based approach to its work.”*
- *“Resourcing: Whether the internal audit activity is adequately resourced to discharge its responsibilities.”*
- *“Quality assessment: Whether the internal audit activity has in place appropriate quality assurance mechanisms to review the quality of work undertaken and for use as a basis for continuous improvement. Such quality assurance may be internally or externally provided.”*

Appendix 1 should also be expanded to address these comments.

Recommendation 7:

We recommend the section “Understanding and Preliminary Assessment of Internal Audit” be reviewed to incorporate the suggestions shown above.

External Audit Understanding of Internal Audit Activities

From our reading of paragraph 12, it appears external audit relies on the work of internal audit “....to identify and assess the risks of material misstatement of the financial report...” The position of The Institute of Internal Auditors does not reflect this approach, and we would suggest the wording be amended:

“The external auditor shall obtain a sufficient understanding of internal audit activities to assess whether the key risks of the organisation have been the subject of internal audit work, and whether this impacts on the extent of the work of external audit.”

Additionally, paragraph 13 and paragraph 15 purport to explain paragraph 12 and paragraph 14 respectively. However, we believe paragraph 13 better explains paragraph 14, and paragraph 15 better explains paragraph 12.

Recommendation 8:

We recommend the wording of paragraph 12 be amended to:

“The external auditor shall obtain a sufficient understanding of internal audit activities to assess whether the key risks of the organisation have been the subject of internal audit work, and whether this impacts on the extent of the work of external audit.”

Organisational Status and Reporting Line for an Internal Audit Activity

We note paragraph 16 deals with the organisational status and reporting line for an internal audit activity. The position of The Institute of Internal Auditors contained in Standard 1110 *Independence and Objectivity* is that: “*The chief audit executive should report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities.*”

Practice Advisory 1110-1: *Organisational Independence* further adds: “*Ideally, the chief audit executive should report functionally to the board and administratively to the chief executive officer of the organisation.*”

Recommendation 9:

We recommend the organisational status and reporting line for an internal audit activity in AUS 604 reflect that suggested by The Institute of Internal Auditors:

“The chief audit executive should report to a level within the organisation that allows the internal audit activity to fulfil its responsibilities. Ideally, the chief audit executive should report functionally to the board and administratively to the chief executive officer of the organisation.”

7. Timing of Liaison and Coordination

As stated earlier, this section should be placed after the “Evaluating the Work of Internal Audit” section.

In paragraph 18, we suggest the word “forward” be inserted in place of the word “tentative” in the second line.

8. Evaluating the Work of Internal Audit

This is a significant area in risk identification and substantive testing minimisation, and does not go into any great detail on what is expected in an internal audit file review. There is no supporting checklist as per the internal audit questionnaire in Appendix 1, and it might be useful to consider whether such a checklist as a guide would be useful.

In paragraph 20 there is no reference to the following points, which should be considered in an evaluation of the work of internal audit.

- *“The testing techniques utilised, including sampling, are adequate”;*
- *“Or not the review was performed in accordance with internal audit plan”;* and
- *“Identified issues and risks were reported to the relevant governance body”.*

In paragraph 21, we suggest the word “external” be inserted before “auditor” in the first line.

Recommendation 10:

We recommend paragraph 20 be amended to include:

- *“The testing techniques utilised, including sampling, are adequate;*
- *Or not the review was performed in accordance with internal audit plan; and*
- *Identified issues and risks were reported to the relevant governance body.”*

9. Appendix 1: Internal Audit – Understanding and Preliminary Assessment Questionnaire

The Questionnaire

The overall heading and concept of the questionnaire is to aid the external auditor in considering all relevant aspects when forming a decision on the adequacy of the internal audit activity. There are two key aspects of the questionnaire that could be improved:

- The questionnaire mentions a “preliminary assessment” but does not explain what it is an assessment of, that is “what aspect of internal audit is being assessed” (this links to our next observation); and
- The questionnaire does not provide guidance on how a conclusion should be reached. As stated above, it is not clear what is being assessed and what type of conclusions can be reached.

We suggest Appendix 1 clearly articulate the purpose of the questionnaire.

Organisational Status

We suggest a new additional question be inserted as question 1:

“Who does the chief audit executive report to and is this appropriate?”

Overall question 1 appears vague and the wording could be improved. What is meant by “management’s view”?

With reference to question 2 (a), in some cases internal audit will review areas at the request of management, for example in the case of a fraud. So, to use the general phrase of being free from “the influences of operational management” is considered to be too broad. The addition of the words “*which would impact on the chief audit executive’s objectivity*” would provide a more accurate guide on whether the internal audit activity could be relied upon.

There is no mention of the internal audit activity’s historical ability to deliver against the annual internal audit plan. Such a question would lead the external auditors down a line of questioning that would result in them forming an opinion of the likelihood of the internal audit activity achieving the current year’s internal audit plan.

There is no mention of an assessment on the internal audit activity’s provision of resources to adequately perform the internal audit role. This may also aid in assessing the likelihood of achieving the annual internal audit plan, but may also

assist in determining if the internal audit activity is capable of covering the minimum level of risk coverage needed for the organisation.

Scope of Function

We suggest a new additional question be inserted as question 4 (a):

“Does internal audit regularly examine risk management, control and governance processes within the organisation.”

Question 4 (a) implies that internal audit should review all “controls over all significant accounting operations”. It would be more appropriate if reference was made to a risk-based internal audit plan that includes consideration of all potential, material risks associated with the financial reporting process. In addition, the exposure draft does not make reference to internal audit sharing their risk assessment methodology and results with external audit – this is something that external audit should also consider when assessing the ability to rely on internal audit’s work. We suggest question 4 (a) be renumbered and amended to:

“Is the internal audit work program aligned to the objectives of the organisation, and is this formulated using a risk-based approach that covers the key organisational risks?”

We suggest a new additional question be inserted as question 4 (c):

“Does the audit committee or chief executive officer approve the internal audit work program?”

In question 4 (b), the discretion of the chief audit executive to change the plan is limited by the requirement that plan changes are generally required to be approved by the relevant governance body, such as the audit committee, therefore this question should reflect this. We suggest the current question 4 (b) become question 4 (e) and be amended to include reference to approval for the chief audit executive to act on suggestions made by the external auditor. We suggest question 4 (b) be amended and renumbered:

“Subject to appropriate approval by the audit committee or chief executive officer, does the chief audit executive have flexibility to act using discretion on suggestions made by the external auditor as to areas to be included in the internal audit work program?”

Question 4 (c) should include that the “professional approach” includes internal audit’s conformance to *The International Standards for the Professional Practice of Internal Auditing* and appropriate audit methodologies. We suggest question 4 (c) be amended and renumbered:

“Do internal audit reports and working papers indicate that internal audit applies a professional approach to its work in accordance with The International Standards for the Professional Practice of Internal Auditing?”

Question 5 (a) include a new sub-question making make reference to internal audit reports being issued on a timely basis. We suggest the new sub-question be:

“Are internal audits conducted within reasonable timeframes and are resulting internal audit reports issued in a timely manner?”

Technical Competence

We suggest a new additional question be inserted at question 7. This is in line with Standard 1312 *External Assessments* contained in *The International Standards for the Professional Practice of Internal Auditing* issued by The Institute of Internal Auditors:

“Has an external assessment, such as a quality assurance review, be conducted at least once every five years by a qualified, independent reviewer or review team from outside the organisation?”

We suggest the current question 7 be renumbered and be amended to include “internal” after “professional” and before “auditor” on the second line, and to also ask whether the chief audit executive is a Certified Internal Auditor.

“Is the chief audit a professionally trained internal auditor and a Certified Internal Auditor?”

We suggest question 8 (a) (ii) be amended to include “relevant” instead of “formal”:

“relevant professional qualifications?”

We suggest question 8 (a) (iii) be amended to include “internal” before “audit”:

“previous internal audit experience?”

We are unsure of the meaning of question 9 and suggest it be deleted.

We suggest question 11 be amended to include “internal” before “auditors” and that the words “Certified Internal Auditors” be included:

“If the entity has a large internal audit function, does it contain an adequate proportion of professionally trained/experienced internal auditors and Certified Internal Auditors?”

Due Professional Care

It may be worth considering adding a new question to the questionnaire covering the use of third party providers in either a co-sourced or fully outsourced approach to the provision of internal audit services. It is important for external audit to gain an understanding of how these relationships are managed by internal audit and/or the relevant governance body. We suggest a new question be added:

“Where the internal audit activity is co-sourced or fully outsourced, is the relationship between the organisation and the third party provider appropriate and well managed?”

We suggest question 12 (b) be amended to reflect the term “chief audit executive”:

“Is the work of internal audit controlled and supervised through managers and supervisors responsible to the chief audit executive, each of whom supervises the work of staff allocated?”

We suggest question 13 (a) be revised to reflect the standards used by the internal audit profession, *The International Standards for the Professional Practice of Internal Auditing* issued by The Institute of Internal Auditors, which are used worldwide and are the only internal audit standards in Australia.

“Does internal audit use written audit programs prepared in conformity with The International Standards for the Professional Practice of Internal Auditing issued by The Institute of Internal Auditors?”

We believe question 13 (b) shows a lack of understanding of the work of an internal audit activity. Whilst cyclical audit programs were heavily used in the past, and may still be used for some audits by some internal audit activities, many topics audited by internal audit are “one off” and require specific audit programs which may only be used once. We suggest question 13 (b) be revised to:

“Are comprehensive audit programs prepared for all internal audit work engagements?”