
INSIDE RISK — commentary and opinion from the Expert Panel

Key insights into internal audit across Australia

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A new survey of 160 heads of internal audit across Australia shows some interesting trends and signals for those involved in governance risk and compliance. Key insights are identified and discussed.

Internal audit independence

It is generally understood that an internal audit function which works with, but is independent of, management is a good thing, and in recent years reporting lines have changed to demonstrate both real and perceived independence of the internal audit function. These days there is little argument against this in principle; however, where the recent Institute of Internal Auditors (IIA) and Protiviti survey, *Achieving High Performance in Internal Audit*, is of most interest is in how this is applied in practice.

The IIA's recent policy proposals suggest four fundamental roles/decisions which should be reserved for an independent audit committee:

- the hiring and firing of the head of internal audit;
- the remuneration of the head of internal audit (both structure and quantum);
- the scope and budget of the internal audit function; and
- ensuring that all internal audit work is reported (at least in summary).

In addition, the head of internal audit should meet regularly with the committee and/or chair in the absence of management to ensure that any issues are brought to a head early, should the need arise. All very sensible stuff and pretty much universally endorsed.

What the survey shows is that although impressive progress has been made in each of these four areas in recent years, there is a long way to go — particularly

outside the ASX 100. The IIA has asked each of its members to benchmark their organisations against these characteristics, and this of itself will drive change, but without regulation there will always be laggards. Given the directions that European regulators have aligned with on similar matters of substance for chief risk officers and other “second line of defence functions”, it will be interesting to see what regulators decide to do here. My bet is that the parallels will be uncanny.

In public sector organisations, these areas remain patchy, with no state or territory exhibiting exemplary practice across all areas, although at least New South Wales seems to have got the blueprint right at the state level and is committed to dealing with this in a structural manner. With the current popularity of splitting up and devolving essential services to a community level, one is left wondering how the governance, risk and control oversight functions will be handled at a local level, given that in most states local government can't even afford the required remuneration to recruit the right talent in this area from the audit committee down, and seem to pop in and out of administration on a regular basis. The devil will be in the detail on this one — but, from where I sit, some of the federal election reforms look like a risky strategy in terms of proper oversight, depth of governance experience, and even basic issues including segregation of duties or maintaining efficiencies of scale on fundamentals such as transaction processing.

Key messages

The market has moved dramatically over the past few years. If you are not in accordance with the IIA's policy recommendations, you are now an outlier, and this is not a good place to be, particularly when these aspects are largely procedural in nature and therefore easily dealt with. Be prepared, however — if your head of internal audit is not up to the grade, a change in personnel may be required. For those in the public sector, watch this space closely, anticipate and get the structures right early when you can, as these are well signposted.

Professional standards

Despite recognition that the *International Standards for the Professional Practice of Internal Auditing* is a fundamental baseline for internal audit practice, the majority of internal audit functions are not yet able to demonstrate full compliance with these standards. As with previous surveys, awareness of the standards is high, and the desire to comply is also high, but audit units haven't taken the necessary steps to self-assess against these standards.

Given that it's nearly 10 years since compliance and independent assessment were made mandatory, this is a poor outcome.

Key messages

If the profession does not self-regulate, then its ability to self-regulate is likely to be taken away from it. This is not necessarily a desirable outcome for the profession, individual organisations or the taxpayer. Given that the standards are a fairly low hurdle and have recently been streamlined, there's really no excuse not to comply. Insist on compliance by your in-house teams and your service providers.

Areas of risk focus

Core financial controls have emerged as the most significant priority for chief audit executives — along with strategic risk, which is making a first appearance in the top five priority areas for the coming year.

Strategic risk has been a hot area of discussion of late, and it is an area which is generally poorly understood. Perhaps in its simplest form it can be understood by looking at the risk capabilities in Diagram 1 below. People are generally comfortable with *compliance* with policies, laws and regulations. Sarbanes-Oxley made sure we're all very comfortable with *reporting*. *Operational risk* deals with efficiency and effectiveness in a business-as-usual environment. *Strategic risk* is what's left — in other words, what happens when conditions change and your capabilities and business models no longer match the world you're operating in. Think black swans, think GFC, think about all the really painful stuff that wasn't on your risk register in the past decade or so

but should have been, and think about the companies which no longer exist. You're on the right track.

To Australia's credit, Australian companies are increasingly recognised as being further up the spectrum than their peers in other nations, but this capability is still embryonic. It is on companies' radar, but at least they are starting to build these capabilities. The IIA in Australia deserves some credit for this, including for some of the public courses and education programs they've run on the subject, which should normally be the domain of other bodies.

Diagram 1: Risk capabilities



Source: ERM an Integrated Framework, Committee of Sponsoring Organisations, Treadway Commission / Todd Davies & Associates

The reality, however, is that the strategic risk capability in most organisations is immature at best. Strategic risk is about gaining greater foresight on emerging conditions and situations that we have not experienced before. Think energy shocks, water shortages and climate change and you're probably starting to scratch the surface. While the wisdom of crowds and the wisdom of elders will help anticipate such things, new capabilities will still be required. But that's the subject of another article.

Synopsis

If you're just about to hit an iceberg, there's not much point focusing all your efforts on the engine room. You need to understand your key vulnerabilities, emerging conditions and key trends, and to resilience test your business and strategies against a range of scenarios — including those you haven't experienced before. If you don't, then you may as well take your risk matrices home and let your kids use them as colouring in paper.

At a glance

- Benchmark your organisation against the IIA's Policy Agenda.
- Make sure your internal audit function is using the *International Standards for the Professional Practice of Internal Auditing*. This applies whether the function is internally or externally sourced.

- Make sure the full spectrum of risk is covered in your risk assessment. If you don't have strong strategic risk capability, you need to develop it or buy-it in.

The full benchmarking report is available at www.iaa.org.au.



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This article represents my own views and not the views of the organisations I work with or for. I am also interested in the results of your children's colouring-in experiments if you decide to go down that path. For mailing lists, Twitter snippets and other free information, go to www.toddavies.com.au.