

20 June, 2017

PGPA Act Review
Review Secretariat
Department of Finance
One Canberra Avenue
FORREST, ACT 2609

Email: PGPAActReview@finance.gov.au

Dear Sir/Madam

Re: Review of Public Governance, Performance and Accountability Act 2013 (PGPA Act) and Rule

The Institute of Internal Auditors - Australia (IIA-Australia) is making this supplementary submission in relation to the Commonwealth Department of Finance's Consultation Draft of the *Public Governance, Performance and Accountability Act 2013 and Rule* (PGPA Act).

IIA-Australia believes a professional, independent and objective internal audit function is one of the key elements of good governance.

In compiling this submission, IIA-Australia has conferred with key members of the profession, including those in the position of Chief Audit Executives within Federal Government. In addition to our own professional guidance both nationally and internationally we have also considered the "International Framework: Good Governance in the Public Sector" as published by the international Federation of Accountants (IFAC) in partnership with the Chartered Institute of Public Finance and Accounting (CIPFA). This framework is seen as the benchmark for good governance in the public sector and included Ian McPhee, who was the Australian Auditor

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General at the time of publication, as part of its International Reference Group. We have also consulted international practices in governance models, in particular governance models in the public sector, as well as domestic legislation, regulation and practices.

Executive Summary

In both private and public sectors across the globe, the establishment of an internal audit function is accepted as best practice, and mandated either in corporate governance codes or legislation in major countries such as the UK and Canada.

1. Following global best practice, IIA-Australia recommends the PGPA Act could be strengthened by mandating an internal audit function in section 17 (2).
2. IIA-Australia notes that the consultation draft Section 17 (Division 3 – Audit Committees for Commonwealth entities) will be amended to require audit committees to be independent members, and guidance material should ensure at least one member has ‘significant’ knowledge of the internal audit function.
3. That specific guidance material be developed for the internal audit function in conjunction with the Department of Finance that includes appropriate qualifications for the Head of Internal Audit (HIA) such as “mandated minimum qualifications” Professional Member of IIA-Australia (post-nominals PMIIA). (See Appendix 1).
4. Clearer direction from the Department of Finance on application of internal audit standards (contained in the International Professional Practices Framework (“IPPF”) would be more helpful to Commonwealth entities beyond the current references in RMG 202, which cites the AUASB, AICD and IIA-Australia’s publication *Audit Committees – A Guide to Good Practice*, and IIA-Australia’s publication *Internal Audit in Australia*.

Submission

The Department of Finance states in its Consultation Draft to have reviewed policies of other jurisdictions to arrive at its recommendations. However, a key element of good governance, the internal audit function, is omitted from its key recommendations and proposed changes to PGPA legislation.

One of the objectives of the independent review was to identify legislative, policy or other changes and initiatives, to enhance public sector productivity, governance, performance and accountability arrangements covered by the Act (page iv).

The independent review also considered approaches to public sector performance in international jurisdictions, and also quotes from the ASX Corporate Governance Principles and Recommendations in reference to audit committees. However, reference to an internal audit function is ignored.

With reference to other sectors and internal audit;

1. Internal audit function – private sector

The ASX Corporate Governance Council includes the internal audit function in its Recommendation 7.3, and soon to be incorporated in part (a) reference to the International Standards Governing the Practice of Internal Auditing (IPPF) in edition four.

The basis for the ASX CGC adopting references to International Standards is that there are no standards issued by the Auditing and Assurance Standards Board (AUASB) that applies to internal auditors.

So effectively, the International Professional Practices Framework (IPPF) issued by the International Internal Audit Standards board, is the only standard that applies to those practicing internal auditing in Australia, and this should be clearly stated and referenced in the PGPA Act and Guidance materials.

The European Confederation of Internal Audit Institutes (ECIIA) conducted a review of the Corporate Governance Codes currently in place in the European Union, and found that 90% of EU member countries require or recommend the presence of internal audit functions in listed companies.

The independent review should consider these examples of governance best practice in its final determination.

2. Internal audit function – public sector

A global survey conducted in 2015 by Arthur Piper for the CBOK IIA Research Foundation of 14,510 respondents in 166 countries found that seven out of ten survey respondents say that the existence of their internal audit function is mandated by law, with a regional high of 88% in Latin America and Caribbean, and 60% in North America.

The UK public sector, particularly HM Treasury, adopted a common set of Public Sector Internal Audit Standards (PSIAS) from April, 2017. The PSIAS includes the mandatory elements of the Institute of Internal Auditors (IIA) International Professional Practices Framework (IPPF), which includes a definition of internal auditing, Code of Ethics and the International Standards for the Professional Practice of Internal Auditing.

On April 1, 2017 the Canadian Treasury Board pursuant to sections 7 and 11.1 of the Financial Administration Act approved \$300 million (Canadian) to establish an internal audit function. The Comptroller General of Canada receives assurance and advice from audit committees and internal audit functions to inform decisions and to build the capacity of qualified and professional internal audit functions across major departments. The requirements also ensure that Chief Audit Executives must have an internal audit certification or professional accounting designation, and that they follow the IPPF.

In South Africa, the Public Finance Act, Act 1 1999 and Treasury regulations make it compulsory for national governments in South Africa to establish an 'effective and efficient' internal audit function.

In Sweden, the internal audit function is legislated in Ordinance for Agencies under the Government, while in Iceland, internal audit is expected to be implemented shortly within central government under Article 65 of the Public Finance Act. In Finland, internal audit is legislated in State Budget Law and in State Budget Decree.

In the OECD, the audit architecture is enshrined in Financial Regulations, the highest form of legal instrument under the Organisation's Founding Treaties. Included is the internal audit function under Regulation 30, which has been established since 2003. Interestingly, audit committees within the OECD monitor the 'independence and effectiveness of the internal and external audit functions'.

All the jurisdictions named follow the IPPF, and outline qualifications required by internal auditors to undertake the function.

While the consultation draft does not recommend major legislative changes to the PGPA Act, IIA-Australia still believes the internal audit function should be mandated in the PGPA Act or supporting regulations, as is the case in other jurisdictions such as the UK, Canada, Europe, and the OECD to name a few.

In Australia, the NSW Government, for example, has issued an Internal Audit and Risk Management Policy for the NSW Public Sector, which is issued as a direction to department heads and statutory bodies listed in schedule 2 and 3 of the Public Finance and Audit Act 1983 (NSW). The policy assists agencies to implement the legislative obligations as set out in section 11 of the Act, and seeks to strengthen internal audit, risk management and governance practices across the public sector.

IIA-Australia supports recommendation 14 in the Consultation Draft (page 3) in that it agrees that audit committees play an important role in reviewing management's oversight of risk. One of the key functions of Audit and Risk committees is the review of the system of internal controls, which is conducted by independent internal auditors. Internal audit's role is to assess the design adequacy and operating effectiveness of the controls management has put in place to manage their risks, and this review should be conducted annually. Internal audit is the only function that is able to provide independent assurance to Audit and Risk Committees, and ultimately to the Accountable Authority.

Moreover, internal audit plays a critical governance role as the third line of defence after front line management and internal finance, risk and compliance functions.

In the "Three Lines of Defence" model, internal audit assumes responsibility for providing overall assurance to the governing bodies.

Since 2013, the Department of Finance has moved to principles-based legislation with the PGPA Act, however, IIA-Australia contends that notwithstanding this move, it would be sensible for the Commonwealth to follow major countries such as Canada, to mandate internal auditing and provide suitable guidance material on internal auditing beyond guidance material in RMG 202.

3. Recommendations and acknowledgements

1. The IIA-Australia recommends the PGPA Act could be strengthened by mandating an internal audit function.
2. IIA-Australia notes that RMG 202 section 1.4.2 Roles and functions of the audit committee references internal audit on page 21.

4. Audit Committees and Internal Audit

IIA-Australia supports independence of audit committee members as stated in point 15.

The PGPA Act mandates an audit committee, which must be constituted, and perform functions (s45 (1) & (2)) in accordance with any requirements prescribed by the PGPA Rules Section 17 (2) and guidance is provided in Resource Management Guide (RMG) 202 (revised 2018). However, insertion in PGPA Rules in section (2) of the internal audit function would strengthen the governance structure within Accountable Authorities.

For example, in the UK Corporate Governance Code, it is clearly stated that the audit committee should monitor and review the effectiveness of the internal audit function. This inclusion would greatly enhance the effectiveness of the PGPA rules, and bring Australia in line with other major countries.

In the RMG 202, there is mention of “internal audits” ensuring that the “coverage takes into account the entity’s primary risks, and recommending approval of the internal audit work plan by the accountable authority”. It also recommends the audit committee “reviewing all internal audit reports, providing advice to the accountable authority on major concerns identified in those reports, and recommending action on significant matters raised – including identification and dissemination of information on good practice”.

IIA-Australia supports this advice, and that at least one of the audit committee independent members, however, should have ‘significant’ knowledge of the “roles of internal and external audit”.

IIA-Australia recommends that audit committee performance, and the performance of audit committee members should be assessed on a periodic basis as established in the audit committee charter. This performance is usually assessed by reviewing the audit committee’s compliance with its formal charter, the level of participation of audit committee members, and the committee’s ability to drive value-added activities and outcomes that are consistent with the organisation’s vision, statutory objectives and strategies.

IIA-Australia contends that the primary responsibility for the Department of Finance's internal audit activities rests with the Head of Internal Audit, as stated in the Department's 2015-16 Annual Report.

The Head of Internal Audit provides the Accountable Authority, through the Audit Committee, with independent assurance that internal controls designed to manage organisational risks and achieve the department's objectives are operating in an efficient, effective and ethical manner. According to the Report, the Head of Internal Audit also implements the annual internal audit plan and manages liaison with the Australian National Audit Office.

The Department of Finance is benefiting from a strong and appropriately structured internal audit function. IIA-Australia believes that all Commonwealth Government departments should benefit from the example it has implemented.

5. Recommendations and acknowledgements

1. IIA-Australia notes that the consultation draft Section 17 (Division 3 – Audit Committees for Commonwealth entities) will be amended to require audit committees to be independent members, and to ensure at least one member has knowledge of the internal audit function.
2. IIA-Australia re-affirms that a new section should be inserted – Section 17 (2) the functions (of the audit committee) must include reviewing the appropriateness of the accountable authority's (insert) (e) an internal audit function.

The Australian National Audit Office *Public Sector Internal Audit Better Practice Guide* (2012) references internal audit and "it is generally expected that individual internal audit staff will be members of the Institute of Internal Auditors and/or other relevant professional associations.

While there are differences among state governments in the definition of acceptable qualifications for internal auditors, there is consistency in requiring internal auditors to be members of the Institute of Internal Auditors. There is currently no such requirement at the Federal level.

6. Recommendation

1. That guidance material be developed for internal audit in conjunction with the Department of Finance that includes appropriate qualifications for the Head of Internal Audit (HIA) such as “mandated minimum qualifications” Professional Member of IIA-Australia (post-nominals PMIIA). (See Appendix 1), beyond references to IIA-Australia’s Internal Audit in Australia.

7. Standards

The Australian Auditing and Assurance Standards Board (AUASB) does not issue standards governing the practice of internal audit. Standards issued by the AUASB are limited to directing the work of “external auditors”.

The *International Standards for the Professional Practice of Internal Auditing* (the *Standards*) issued by the International Internal Audit Standards Board is the only set of standards governing the global profession of internal audit.

For these reasons, the *Standards* should be clearly referenced in any guidance material.

This approach was endorsed by the Australian National Audit Office in their *Public Sector Internal Audit Better Practice Guide* (2012) which references the *International Standards for the Professional Practice of Internal Auditing*.

The Department of Finance’s own internal audit reports reference the *Standards* as the basis for conducting internal audits, however, this guidance is absent in any of the Resource Management Guides.

IIA-Australia notes that the Commonwealth Department of Finance in RMG 202 does cite the AUASB, AICD and IIA-Australia’s publication *Audit Committees – A Guide to Good Practice* which does reference the *Standards*, and IIA-Australia’s

publication *Internal Audit in Australia*, however, clearer direction from the Department of Finance would be more helpful for entities.

In the United Kingdom, the Financial Reporting Council's *Guidance on Audit Committees* issued in April 2016 requires the "internal audit function has unrestricted scope, and is equipped to perform in accordance with appropriate professional standards for internal auditing". The *Standards* are footnoted.

The European Commission, which conducts 150 internal audits annually, follows the *Standards*.

8. Summary of Recommendations

1. IIA-Australia re-emphasises that the internal audit function should be mandated in the *Public Governance, Performance and Accountability Act 2013* (PGPA Act).
 - a. Insert new section – Section 17 (2) the functions (of the audit committee) must include reviewing the appropriateness of the accountable authority's (insert) (e) an internal audit function.
2. That the next revision of the Resource Management Guide (RMG 202) include appropriate qualifications for the Head of Internal Audit (HIA) such as "mandated minimum qualifications" Professional Member of IIA-Australia (post-nominals PMIIA). (See Appendix 1).
3. IIA-Australia (in conjunction with the Department of Finance) should develop a Resource Management Guide on Internal Audit (see Appendix 1 for a draft). This could follow a revised version of the ANAO's Better Practice Guide, which IIA-Australia consulted on.

IIA-Australia acknowledges that that the Department of Finance has included The IIA-Australia's *Internal Audit in Australia*, which references the *Standards*, in their updated guidance material (RMG's) for internal auditors to follow whether they are in-house or outsourced.

About the Institute

The Institute of Internal Auditors (The IIA) is the global professional association for internal audit practitioners, with global headquarters in the USA, and with Institutes throughout the world including Australia (IIA-Australia). The IIA was established in 1941, and now has more than 196,000 members from 190 countries throughout the world, including 3,000 members in Australia.

As the chief advocate of the internal audit profession, The IIA serves as the profession's international standard-setter, sole provider of globally accepted internal auditing certifications, and principal researcher and educator.

The IIA sets the bar for internal audit integrity and professionalism around the world with its *International Professional Practices Framework (IPPF)*®, a collection of guidance that includes the *International Standards for the Professional Practice of Internal Auditing*, and the Code of Ethics for internal auditors.

The Code of Ethics states the principles and expectations governing behaviour of individuals and organisations in the conduct of internal auditing. It describes the minimum requirements for conduct and behavioural expectations, rather than specific activities.

The *International Standards for the Professional Practice of Internal Auditing* issued by the International Internal Audit Standards Board of The IIA are the 'Standards' governing internal auditing worldwide.

There are no legislated standards applicable to internal auditing in Australia.

Our members work in internal auditing, risk management, governance, internal control, information technology audit, education, and security.

10. Appendix 1

Recommended Guidance – Internal Audit Qualifications

The head of internal audit should be suitably qualified. Unqualified Heads of Internal Audit risk misinterpretation and non-conformance with the Standards

contained in the IPPF. This in turn undermines the basis for acceptable internal audit reporting to the board through the Audit Committee.

There are a number of ways to be suitably qualified as cited below. It should be stressed that an accountant, for instance, does not make an internal auditor.

The *Financial Accountability Act (2009)* in Queensland, Section 78, for example, mandates that accountable officers nominate an appropriately qualified person as head of internal audit.

Information Sheet 2.6 *Head of Internal Audit* states “mandated minimum qualifications” include Professional Member of IIA-Australia (PMIIA), CPA or above, Chartered Accountant, or MIPA.

All NSW Chief Audit Executives must have “appropriate professional qualifications” or demonstrate high-level experience, which came into effect in 2017. The footnote in TPP 15-03 page 24 cites “Appropriate professional certification might include those which would be recognised by the Institute of Internal Auditors, CPA Australia or Institute of Chartered Accountants.

Under Victorian Treasurer’s Standing Directions 3.2.2.1 (d) the internal audit function has to have “suitably experienced and qualified” internal auditors. Guidance documents supporting the Standing Directions issued by Treasury state that internal auditors must have a professional designation such as membership of IIA-Australia, which is not mandatory but a “relevant qualification”.

The Australian National Audit Office *Internal Audit Best Practice Guide (2012)* references internal audit and “it is generally expected that individual internal audit staff will be members of the Institute of Internal Auditors and/or other relevant professional associations such as CPA Australia.

IIA–Australia Better Practice Guide – Internal Audit

IIA-Australia recommends that Department of Finance work with IIA-Australia to revise and update the ANAO’s Better Practice Guide to assist departments. This guide would assist accountable authorities of Commonwealth entities, governing

bodies of Commonwealth companies, audit committee members and internal auditors.

IIA-Australia would produce this guide at no cost to the Department of Finance.

This guide details considerations for establishing and operating an internal audit function to provide independent, objective assurance and advice to accountable authorities and governing bodies, and would provide guidance to accountable authorities and governing bodies on determining the internal audit charter.

The guide would support the implementation of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act) and the Public Governance, Performance and Accountability Rule 2014 (PGPA Rule), which took effect on 1 July 2014.

Resources

Available in RMG 202, and references that are included

- Institute of Internal Auditors–Australia, *Internal Audit in Australia* (1st edition, 2016)
- Institute of Internal Auditors–Global, *International Professional Practices Framework* (2017)
- Auditing and Assurance Standards Board, Australian Institute of Company Directors and Institute of Internal Auditors–Australia: *Audit Committees: A guide to good practice* (3rd edition, 2017).

Other relevant publications & references that should be included:

- Institute of Internal Auditors–Global, *International Professional Practices Framework* (2017)
- www.iaa.org.au

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