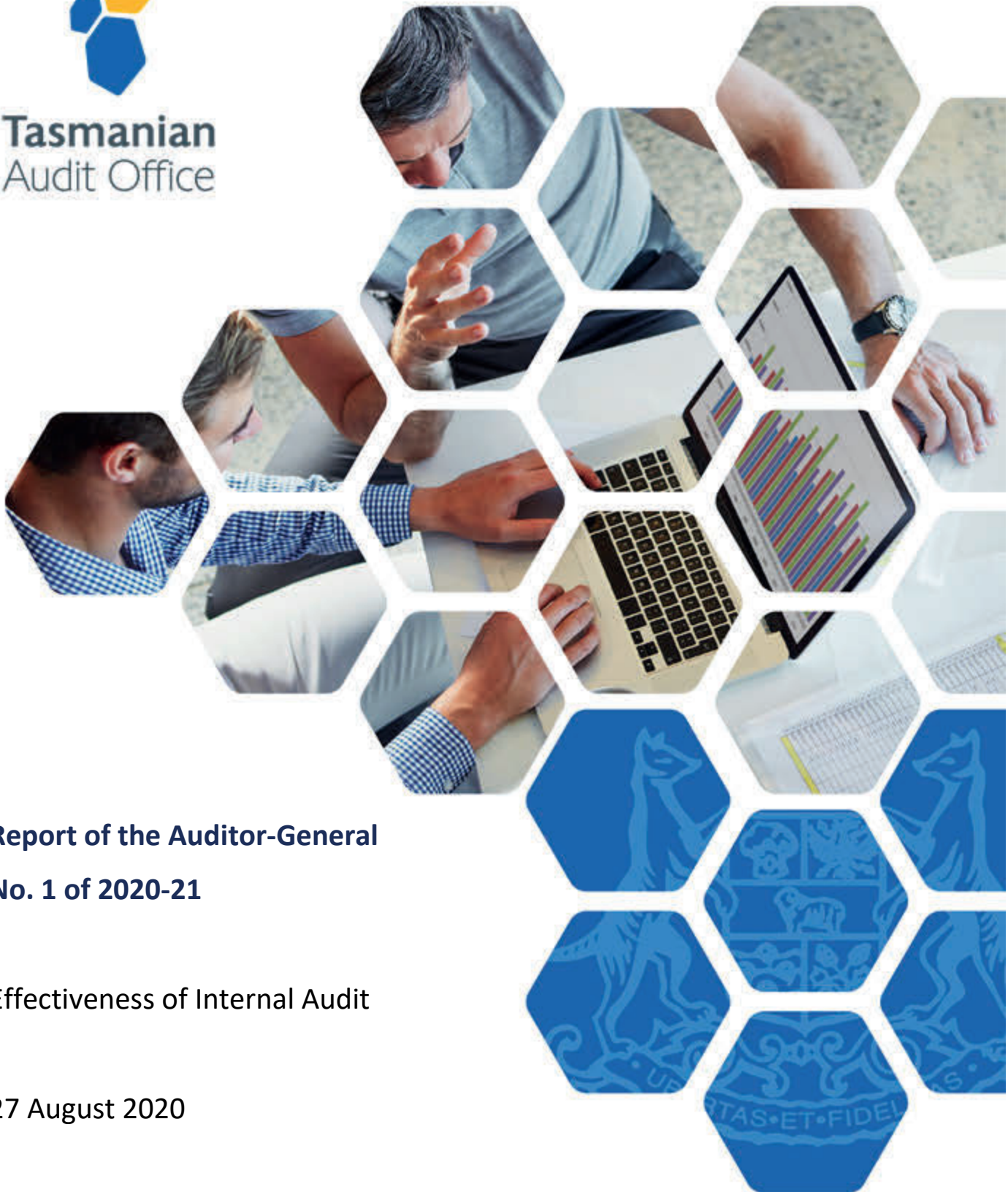




**Tasmanian**  
Audit Office



**Report of the Auditor-General  
No. 1 of 2020-21**

Effectiveness of Internal Audit

27 August 2020

## The Role of the Auditor-General

The Auditor-General's roles and responsibilities, and therefore of the Tasmanian Audit Office, are set out in the *Audit Act 2008* (Audit Act). The Auditor-General's role as Parliament's auditor is unique.

Our primary responsibility is to conduct financial or 'attest' audits of the annual financial reports of State entities. State entities are defined in the Interpretation section of the Audit Act. We also audit those elements of the Treasurer's Annual Financial Report reporting on financial transactions in the Public Account, the General Government Sector and the Total State Sector.

Audits of financial reports are designed to add credibility to assertions made by accountable authorities in preparing their financial reports, enhancing their value to end users. Following financial audits, we report findings and outcomes to Parliament.

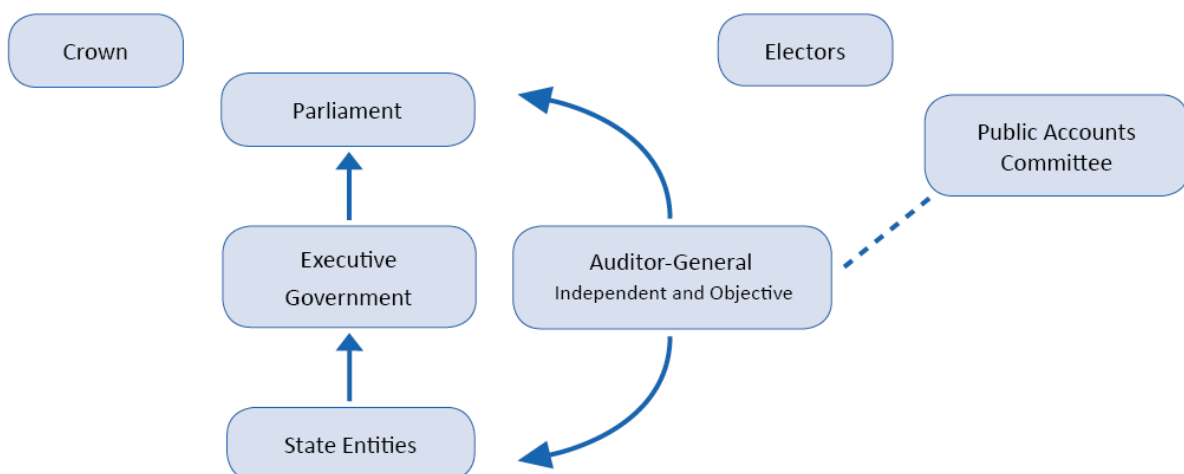
We also conduct performance audits and compliance audits. Performance audits examine whether a State entity is carrying out its activities effectively and doing so economically and efficiently. Audits may cover all or part of a State entity's operations, or consider particular issues across a number of State entities.

Compliance audits are aimed at ensuring compliance by State entities with directives, regulations and appropriate internal control procedures. Audits focus on selected systems (including information technology systems), account balances or projects.

We can also carry out investigations but only relating to public money or to public property. In addition, the Auditor-General is now responsible for state service employer investigations.

Where relevant, the Treasurer, a Minister or Ministers, other interested parties and accountable authorities are provided with opportunity to comment on any matters reported. Where they choose to do so, their responses, or summaries thereof, are detailed within the reports.

### The Auditor-General's Relationship with the Parliament and State Entities





2020  
PARLIAMENT OF TASMANIA

**Report of the Auditor-General No. 1 of 2020-21**  
**Effectiveness of Internal Audit**

**27 August 2020**

Presented to both Houses of Parliament pursuant to  
Section 23 of the *Audit Act 2008*

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27 August 2020

President, Legislative Council  
Speaker, House of Assembly  
Parliament House  
**HOBART TAS 7000**

Dear Mr President, Madam Speaker

**Report of the Auditor General No. 1 of 2020-21: Effectiveness of Internal Audit**

This report has been prepared consequent to examinations conducted under section 23 of the *Audit Act 2008*. The objective of the review was to express a reasonable assurance opinion on the effectiveness of audit committees and internal audit functions of government departments.

Yours sincerely



Rod Whitehead  
**Auditor-General**

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# Independent assurance report

This independent assurance report is addressed to the President of the Legislative Council and the Speaker of the House of Assembly. It relates to my performance audit (audit) on the effectiveness of audit committees and internal audit functions across all nine Tasmanian Government departments (departments).

## Audit objective

The objective of the audit was to examine whether the audit committees and internal audit functions of departments were operating effectively and delivering a positive impact on departmental performance. The audit identified potential lessons and opportunities for improvement to assist departments increase the effectiveness of their audit committees and internal audit functions.

## Audit scope

The audit covered the following departments:

- Communities Tasmania
- Education (DoE)
- Health (includes Tasmanian Health Service)
- Justice
- Police, Fire and Emergency Management (DPFEM)
- Premier and Cabinet (DPAC)
- Primary Industries, Parks, Water and the Environment
- State Growth
- Treasury and Finance (Treasury).

## Audit approach

The audit was conducted in accordance with Australian Standard on Assurance Engagements ASAE 3500 *Performance Engagements* issued by the Australian Auditing and Assurance Standards Board, for the purpose of expressing a reasonable assurance conclusion.

In this Report, '*internal audit function*' is used to define internal audit services provided to a department by either in-house internal auditors, out-sourced internal audit service providers (contractor(s)) or a co-sourced model involving a combination of both. The internal audit function does not include the audit committee or actions it undertakes.

The audit evaluated the following criteria and sub-criteria:

1. Are audit committees and internal audit functions effective in providing advice and assurance to the Secretary?
  - 1.1 There is a common understanding of the advice and assurance needs of the Secretary.
  - 1.2 There is effective communication between the Secretary, audit committee and internal audit function.
  - 1.3 The audit committee and internal audit function are effective in meeting the needs of the Secretary, including adding value.
2. Are secretaries effective in overseeing and managing audit committees and internal audit functions?
  - 2.1 Sufficient resources are provided to enable audit committees and internal audit functions to fulfil their function and purpose.
  - 2.2 Audit committees and internal audit functions have sufficient authority and access to undertake their work.
  - 2.3 The audit committee and internal audit function are subject to performance assessment.
3. Do audit committees effectively provide objective challenge and assurance?
  - 3.1 Audit committees have the right skills and capability to function effectively.
  - 3.2 Audit committees have a clearly defined function, purpose and responsibility covering governance, risk management and control processes.
  - 3.3 Audit committee members have sufficient independence from the department.
4. Are audit committees and internal audit functions effective in strengthening departmental governance, risk management and control processes?
  - 4.1 Internal audit work plans consider departmental objectives, priorities and risks and encompass governance, risk management and control processes.
  - 4.2 Internal audit work plans are subject to periodic review and approval.

## **Responsibilities of management**

Heads of Agency were responsible for the effective operation of audit committees and internal audit functions in delivering a positive impact on departmental performance.

## **Responsibilities of the Auditor-General**

In the context of this audit, my responsibility was to express a reasonable assurance conclusion on the effectiveness of audit committees and internal audit functions of the departments.

## Independence and quality control

I have complied with the independence and other relevant ethical requirements relating to assurance engagements, and apply Auditing Standard ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, and Other Assurance Engagements* in undertaking this audit.

## Conclusion

It is my conclusion departmental internal audit functions did not perform, in terms of efficiency and effectiveness, with respect to certain criteria or sub-criteria of the performance engagement. This is because, despite the implementation of Treasurer's Instruction FC-2 *Internal Audit* by all departments, there is variable quality in communication between department secretaries and audit committee chairs resulting in a lack of clarity regarding the performance and impact of internal audit functions. Audit committees are not sufficiently independent and as a consequence not always able to provide the appropriate level of scrutiny and challenge to departmental management. Training and induction for audit committee chairs and members is limited and does not help to build the capability of audit committees. While internal audit work plans are adequately resourced they are not always aligned with key departmental risks and priorities.



Rod Whitehead  
**Auditor-General**  
27 August 2020

# Executive summary

## Summary of findings

Independent scrutiny of performance, processes and procedures, ensuring appropriate safeguards are in place, is an important aspect of an organisation's activities. The provision of this advice and assurance can drive improvement and importantly act as a valuable tool for managing risk effectively and appropriately within an entity. For many organisations rigour is brought to this scrutiny through an internal audit function.

Treasurer's Instruction FC-2 *Internal Audit* (FC-2) mandates each department have an audit committee reporting to its Secretary supported by an internal audit function that undertakes audit activities outlined in a forward work plan. Our audit examined the impact of the internal audit function across all nine departments.

The audit committee reports to the Secretary and we wanted to assess if the function was meeting the Secretary's needs and requirements, was appropriately resourced, had the right level of independence to challenge management and whether audit activity was focused on improvements in key areas.

FC-2 has been implemented by all departments, with audit committees convening on a regular basis and work plans in place to deliver a range of internal audit activity. However we found variability across departments regarding the effectiveness of the internal audit function in several areas.

For most departments, there were established communication lines between the Secretary and audit committees, however, communication was much more effective when it was regular and formalised. For four departments, communication was not as strong or effective which led to a poorer understanding of whether the audit committee was meeting the needs of the Secretary and its role in facilitating organisational improvement. Audit committees and internal audit functions were effective in providing assurance to secretaries but the provision of advice regarding departmental performance supporting strategic objectives and priorities was less well developed.

Assessing value add and overall performance within the internal audit function was underdeveloped for most departments. There had been progress in recent years but much remained to be done to assess if the function was effective and provided value for the audit work and scrutiny undertaken.

While resourcing of the internal audit function was largely based on historical budget-setting, overall resourcing was increasing and becoming more agile. Most departments were able to find additional resources when an emerging risk was identified and needed to be added to the internal audit work plan. All audit committees and internal audit functions had sufficient authority and access ensuring audit work could be undertaken without interference or internal barriers.

Audit committees' monitored and followed up on the progress of audit recommendations but there remained barriers to implementation. These included recommendations that could not be implemented, lack of resources to facilitate implementation and lack of commitment or resistance by managers. This is of vital importance as poor implementation of recommendations significantly inhibits the effectiveness of the internal audit function in driving improvements.

The level of independence of audit committees that ensured effective challenge to departmental management was improving but remains a significant issue. Independence was still not consistently strong enough across all departments. All audit committees, except one, had at least one independent member. But importantly, five departments, still retained more internal rather than external independent membership. Several departments recognised the need to increase the number of independent members including appointing an independent audit committee Chair. However, we identified a level of resistance still remaining to changing the composition of audit committees. Training and induction for audit committee members, both internal and external, was underdeveloped in most departments. In addition, role profiles and a matrix for the skills and experience required on the audit committee were rarely established.

Internal audit work plans did not consistently link to strategic risks, objectives and priorities to ensure key areas of departmental activity were covered. This was a key issue reported to us by audit committee members from many departments, highlighting the need for the internal audit function to have a more strategic focus and not only examine compliance and assurance matters.

There are nine recommendations in this Report to further strengthen audit committees and the internal audit functions within departments. Appendix 1 includes a check list of good practice which may assist audit committees in implementing our recommendations.

I would like to thank secretaries, audit committee chairs and members, department staff involved in internal audit functions and contracted internal audit service providers (contractors) for their help in completing this audit.

## Recommendations

We have made nine recommendations to assist departments strengthen audit committees and internal audit functions:

1. Secretaries to ensure there are regular, formal meetings between the audit committee Chair and Secretary where the effectiveness of the internal audit function is discussed.
2. Audit committees to facilitate working collaboratively across departments to benchmark internal audit activity to better understand if the internal audit function is adding value.
3. Secretaries ensure audit committees have an independent Chair and a majority of independent members to enable effective challenge of departmental management.

4. Audit committees to develop role profiles and a skills matrix for audit committee members and periodically assess the composition of the audit committee.
5. Audit committees to improve induction and training provided to all audit committee members and internal auditors.
6. Audit committees to improve the links between internal audit plans, departmental risks and strategic objectives to ensure coverage of primary risks and drive more significant improvements in departmental outcomes.
7. Audit committees review effectiveness of audit recommendations in driving improvements and improving outcomes.
8. Ensure secretaries conduct annual performance assessments of the audit committee with periodic external assessments.
9. Audit committees to review committee charters to ensure they follow Treasury guidance.

## Submissions and comments received

In accordance with section 30(2) of the *Audit Act 2008* (Audit Act), a summary of findings or Report extract was provided to the Treasurer, and other persons who, in my opinion, had a special interest in the Report, with a request for submissions or comments.

Submissions and comments we receive are not subject to the audit nor the evidentiary standards required in reaching an audit conclusion. Responsibility for the accuracy, fairness and balance of these comments rests solely with those who provided the response. However, views expressed by the responders were considered in reaching audit conclusions.

Section 30(3) of the Act requires this Report include any submissions or comments made under section 30(2) or a fair summary of them. Submissions received are included below.

### Response from the Premier and Treasurer

I consider that the role of the internal audit function within agencies and the need for appropriate independence on audit committees are essential to enhance performance and assist agencies in maintaining a comprehensive framework of internal controls.

I note from the draft report that while there have been improvements in the internal audit function of agencies, your report indicates more remains to be done to assess if the function is effective and provides value for the audit work done and the scrutiny undertaken.

I also note that your report indicates more needs to be done to increase the level of independence of audit committees, the need for improved communication lines between Secretaries and audit committees and for agencies to improve the link between internal audit work plans and strategic risks, objectives and priorities.

It is my expectation that Accountable Authorities will commit to implementing relevant recommendations to improve the internal audit function within their agencies.

**The Honourable Peter Gutwein**

**Premier and Treasurer**

## **Department of Communities Tasmania**

The Audit Committee and Internal Audit function are important aspects of governance and I am committed to ensuring their effective operation. I welcome the findings in relation to independence of the Audit Committee and acknowledge the importance of ensuring that recommendations can be implemented.

I am pleased to note that the Department has an independent Audit Committee with a mix of independent and internal members who have the relevant skills and expertise to undertake their role. This is well supported by an Annual Audit Plan. I am committed to ensuring that the Internal Audit remains an effective mechanism for the Agency.

**Michael Pervan**

**Secretary**

## **Department of Education**

The Department of Education (DoE) agrees in principle to the recommendations made in the report. It is noted that the observations and recommendations made in the summary report have been aggregated for agencies included in the audit. The comments below illustrate DoE's past and current work regarding the effectiveness of the DoE's Risk Management and Audit Committee (RiMAC), and internal audit functions as they relate to the observations and recommendations made in the report.

RiMAC is established under a formal Charter approved by the Secretary. RiMAC's Charter is formally reviewed and approved by the Secretary each year. This is to ensure that it follows not only Treasurer's Instruction FC-2 *Internal Audit*, but that it effectively outlines the roles and responsibilities of RiMAC members, establishes RiMAC's authority to obtain information and resources, and establishes roles and responsibilities for those who may interact with RiMAC.

Although not required by Treasurer's Instruction FC-2 *Internal Audit*, RiMAC has committed to strengthening its independence through extending the number of independent members and the eventual appointment of an independent Chairperson. In 2019, RiMAC commenced an Executive Group approved recruitment program to increase the number of independent members to be the majority. From this process, which was slightly delayed due to the impact of COVID-19, a second independent member will join RiMAC in September 2020.

The recruitment program includes the development of an induction program, role profiles and skills matrices to ensure that independent members appointed to RiMAC are able to

fulfil their responsibilities as articulated in the RiMAC Charter. These role profiles and skills matrices will consider RiMAC's needs in relation to expertise, specific skill sets and personal attributes and perspectives and inform any future training needs of RiMAC members.

As required by Treasurer's Instruction FC-2 *Internal Audit*, RiMAC is supported by an internal audit function that has a three year forward work plan. This plan was developed after considering DoE's strategic plan and associated key risks and mitigation strategies, priority actions, compliance obligations and fraud risk. The plan is revised annually by RiMAC to ensure the audit program remains relevant and contemporary in supporting RiMAC in providing advice and assurance to the Secretary.

RiMAC receives all internal reports and assesses the recommendations and management responses. Management formally reports back to RiMAC on a regular basis regarding the progress of implementing recommendations and timeframes for completion to assist RiMAC in maintaining the effectiveness of the internal audit function. Internal audit reports and management updates are formally provided to the Secretary for review and consideration.

DoE is committed to ensuring that RiMAC and the internal audit function are operating effectively and having a positive impact on DoE. DoE will review performance assessment measures, taking into account the internal audit function on DoE is provided through a Departmental business unit. DoE is also willing to participate in any co-ordinated cross agency benchmarking activity.

**Rob Williams**

**Acting Secretary**

## **Department of Health**

The Audit Committee and Internal Audit function are important aspects of governance and I am committed to ensuring their effective operation. I welcome the findings in relation to independence of the Audit Committee, the importance of linking the assurance process with risk and objectives and the need to effectively manage recommendations made.

I am pleased to note that the Department has an independent Audit Committee with the relevant skills and expertise, supported by a clear Charter, and this was acknowledged as part of the audit process. An annual performance process is in place, which includes consideration of skills and training, and I will look at opportunities to enhance this process. As part of the continuous improvement of the function, a skills matrix is currently being developed and Audit Committee members are encouraged to maintain and develop their skills and knowledge.

I am committed to ensuring internal audit recommendations are effective and will be enhancing the existing recommendation monitoring process with further integration with risk culture measures.

**Ross Smith**

**Acting Secretary**



## **Department of Justice**

As you would be aware, the Department of Justice (the Department) has recently appointed a new internal audit provider following a tender process for these services. As part of the on-boarding process for the internal audit provider, the Department has commenced a review of its strategic risk register and how we manage internal audit and risk across the organisation. This includes the role of our Internal Audit and Risk Management Committee so the timing of this performance audit will no doubt enhance this work.

I am supportive of all of the recommendations and they will be considered as part of our strategic risk register development and review of internal audit and risk management governance, processes and procedures.

Thank you again for the opportunity to comment on the report.

**Ginna Webster**

**Secretary**

## **Department of Police, Fire and Emergency**

With reference to the specific findings in the report, my summary response is as follows:

- With regards to the oversight of the Audit and Risk Committee (Committee) I can provide assurance that I have visibility of the internal audit portfolio. I meet with the committee's Chairperson on a fortnightly basis to discuss internal audit matters and I am formally briefed on the progress and outcomes of the committee's work.
- Our committee members are obliged to follow the DPFEM Audit and Risk Committee Terms of Reference and On and Off Boarding Induction Manual. These documents outline the committee's role and function, the expectations and specific skill set required by each member and general committee induction to help support all new members. The membership and composition of our committee is determined on an annual basis, as assessed by the Chairperson.
- I note that an audit recommendation is to consider an independent Chairperson. The DPFEM Audit and Risk Committee is comprised of representatives from Tasmania Police, Tasmania Fire Service, State Fire Commission, Business and Executive Services and an independent member. The breadth of membership is extensive and not siloed from a particular business area, therefore I believe it provides the level of scrutiny and challenge required. I am confident that this meets our needs at this time as tested in our recent biannual assessment of the committee's performance.
- As a department we are acutely aware of the risks that may hinder the achievement of our business strategy. Severe risks are escalated through the Agency Management Group for visibility and monitoring. If required, the risk is cascaded to

the committee to seek their assurance on the appropriate controls and mitigation plans. DPFEMs internal audit work plan is informed by these risks. Therefore, the DPFEM audit plan is intrinsically linked to the department's risk register. DPFEM ensures that critical audit findings are assessed as key business priorities for the forthcoming year, which are reported and measured quarterly.

- The DPFEM Audit and Risk Manager periodically meets with other departmental risk managers to work with and to discuss internal audit and risk management activities. We share and provide guidance on contemporary audit and risk practices and keep abreast of internal audit activities occurring in other departments. This ensures that our internal audit and risk function is adding value to the department whilst providing support to other departments.

Thank you for allowing us an opportunity to respond.

**Darren Hine**

**Secretary**

### **Department of Premier and Cabinet**

The Department of Premier and Cabinet (DPAC) will review the operation of its audit committee and internal audit functions having regard to the recommendations as it emerges from the COVID-19 pandemic. DPAC will also use the checklist of good practice provided in the Report's Appendix 1 to ensure its internal audits are delivering a positive impact on its departmental performance.

Thank you again for your letter and for providing the opportunity to respond.

**Jenny Gale**

**Secretary**

### **Department of State Growth**

I have reviewed the Summary Report and Recommendations and have no further comments to add to the report. I am committed to implementing recommendations that are not currently in effect in the Department. The Risk and Audit Committee will be overseeing the implementation and report regularly to the Executive on progress.

**Kim Evans**

**Secretary**

## Department of Treasury and Finance

With regard to the independent audit assurance report conclusions, I offer the following observations:

- There is a common understanding of the advice and assurance needs of my office. This comes with the high level of communication that occurs between myself, the Chair and Treasury's Executive member on the Audit and Risk Management Committee (ARMC).
- Treasury has two independent members on the ARMC, one of whom is the Chair. I am satisfied that Treasury's ARMC has a high level of independence.
- The findings in relation to training and induction are accepted. Treasury has reviewed and expanded its induction processes for the incoming Chair and new audit members to include understanding of the Agency's operations, key staff and culture and the inductee's roles and responsibilities.
- Ongoing professional development and an assessment of the training needs of internal audit members will also be reviewed in terms the most appropriate mix of in-house training to support an enhanced understanding of Treasury's operations as well as ensuring audit members are able to stay informed of current industry practice and issues.
- I consider that Treasury's internal audit function is appropriately resourced and able to deliver an audit plan that covers Treasury's primary risk areas. Treasury has a three year audit strategy that is implemented on an annual basis. Each annual audit plan is reviewed and adjusted prior to commencement to ensure that new or developing departmental risks and priorities are incorporated into the plan. Further, key Agency risks and priorities are regularly assessed by Treasury's Executive and the ARMC and additional audits can be initiated at any time during the annual audit plan on recommendation from the Chair or Treasury's Executive members.

Thank you for the opportunity to comment on this audit report.

**Tony Ferrall**

**Secretary**

# 1. Introduction

## What is internal audit?

1.1 Internal audit is defined by the Institute of Internal Auditors Australia (IIA Australia) as *'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.'*

1.2 The role of internal audit is seen by IIA Australia as:

- being independent of management
- serving the needs of the organisation as a whole and, in particular, the audit committee, chief executive officer and senior management
- focusing on evaluating controls designed to assure the accomplishment of the organisation's goals and objectives
- reviewing governance, risk management and control processes according to risk
- being directly concerned with the prevention of fraud in any activity reviewed<sup>1</sup>.

1.3 Internal audit is a vital component of many public sector entities due to its role in providing objective assurance and advice. Assurance is defined as independent confirmation and confidence<sup>2</sup> focusing on improving efficiency, evaluating risks, protecting assets, assessing the effectiveness of controls and ensuring public sector entities comply with legislation and their policies and procedures.

1.4 Internal audit is often described as the third line of organisational defence with operational management and components of internal governance, such as risk management, compliance and internal controls, being the first and second lines of defence<sup>3</sup>. This is explained further in Figure 1.

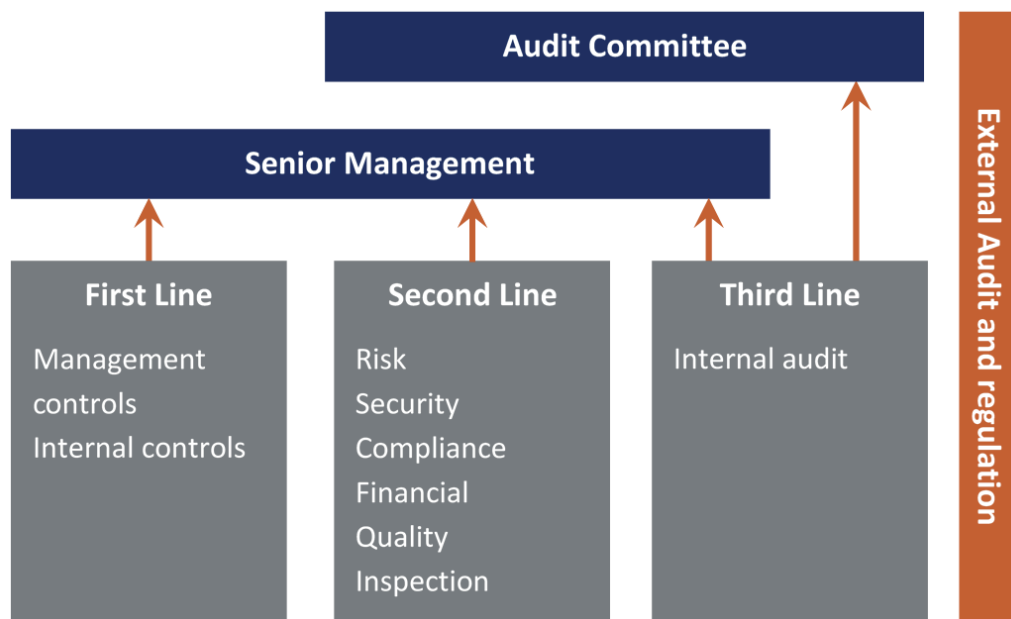
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<sup>1</sup> Institute of Internal Auditors, Factsheet: Internal Audit versus External Audit, 2018, Refer: [https://www.iaa.org.au/sf\\_docs/default-source/technical-resources/2018-fact-sheets/internal-audit-versus-external-audit.pdf](https://www.iaa.org.au/sf_docs/default-source/technical-resources/2018-fact-sheets/internal-audit-versus-external-audit.pdf)

<sup>2</sup> Institute of Internal Auditors, The IIA's Three Lines Model, Refer: <https://global.theiia.org/about/about-internal-auditing/Public%20Documents/Three-Lines-Model-Updated.pdf>

<sup>3</sup> Institute of Internal Auditors, Position Paper: The Three Lines of Defence in Effective Risk Management and Control, 2013, Refer: <https://na.theiia.org/standards-guidance/position-paper/three-lines-of-defense>

Figure 1: Three lines of organisational defence



Source: Graphic taken from The IIA Position Paper *The Three Lines of Defense in Effective Risk Management and Control* published in 2013, adapted from ECIIA/FERMA *Guidance on the 8th EU Company Law Directive, article 41*

- 1.5 The first line of defence is operational managers who have ownership, responsibility and accountability for directly assessing, controlling and mitigating risks. They are also responsible for implementing corrective actions to address process and control deficiencies.
- 1.6 The second line of defence consists of various risk management and compliance functions to monitor and facilitate the implementation of effective risk management practices by operational management and assist risk owners in reporting adequate risk-related information throughout the organisation.
- 1.7 The third line of defence is internal audit whose independence and objectivity differentiates it from the first and second lines.

## Internal audit in departments

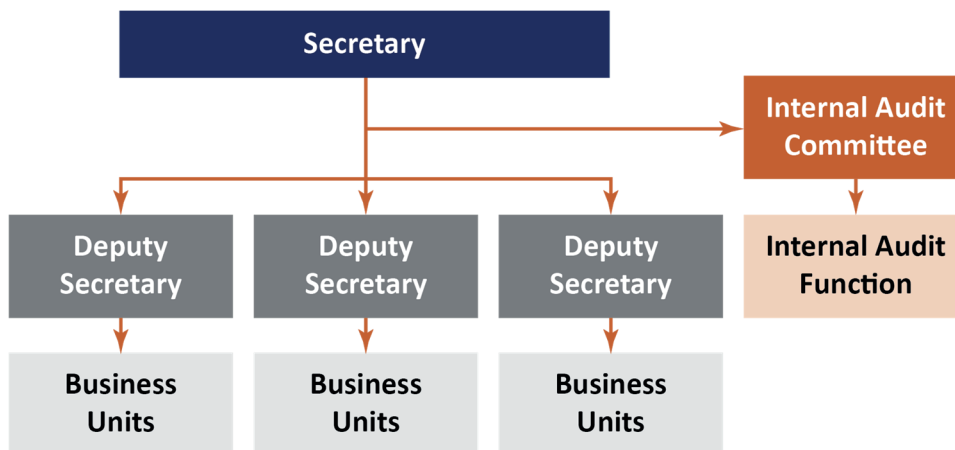
- 1.8 FC-2 directs the Secretary to have an:
  - internal audit function, which provides for the ongoing review of the effectiveness of internal governance, risk management and control processes in a department
  - audit committee comprising at least three persons with relevant, qualifications, knowledge, skills or experience
  - internal audit charter (or terms of reference, but hereinafter referred to as the Charter), which specifies the responsibilities for those undertaking the internal audit function

- internal audit plan detailing the program of internal audit activity taking into consideration department risks and objectives.

1.9 The purpose of an internal audit function and audit committee is to provide objective advice and assurance to the Secretary.

1.10 Good practice suggests the audit committee be established by, and report directly to, the Secretary, with the internal audit function reporting directly to the audit committee. This reporting structure (refer to Figure 2) is a key factor in maintaining the independence of the audit committee and internal audit function as it prevents them being aligned with any departmental branch unit.

Figure 2: Reporting structure



1.11 Independence is important in enabling audit committees to discharge their responsibilities in providing objective challenge and assurance free from potential conflicts of interest. Under FC-2, audit committees are not required to have an independent Chair and it is not mandatory to have independent members. The *Financial Management – Better Practice Guidelines*<sup>4</sup> (the Guidelines) provide additional guidance to secretaries and responsible officers, to assist compliance with FC-2. The Guidelines recommend appointing audit committee members who exhibit an independence of mind and who do not act as representatives of a particular area within the department or a particular stakeholder interest. The Guidelines also state audit committees should not have any management responsibilities and have policies in place to identify changing relationships or circumstances that may affect the independence of members.<sup>5</sup>

<sup>4</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016

<sup>5</sup> *Ibid*, pp 6-7.

## Models for the delivery of internal audit

1.12 There are three common models for the delivery of internal audit:

- in-house, with departmental staff performing the work
- contractors
- a combination of both in-house and contractors (mixed delivery or co-sourced internal audit).

1.13 The decision on which mode of delivery is most suitable is influenced by the size, resourcing and complexity of a department. All but three departments<sup>6</sup> have outsourced their internal audit function to contractors, with contract management assigned to a departmental officer within the department. Our audit does not comment on the selected model of internal audit delivery but focuses on the effectiveness of the internal audit function.

## Identifying good practice

1.14 In addition to the Guidelines issued by Treasury, good practice regarding audit committees and internal audit functions can be found in:

- requirements and guidance issued by other Australian Governments
- Auditor-General audit reports and better practice publications and insights issued in Australia and internationally
- IIA Australia's public sector guidance *Effective Internal Auditing in the Public Sector - a good practice guide*.

## Previous Auditor-General audits and reviews

1.15 In 2004 we undertook an audit<sup>7</sup> to determine the efficiency and effectiveness of internal audit services in meeting corporate governance objectives in the Tasmanian public sector. The scope of this audit included two departments, a government business and one other state entity. The audit also examined why four other departments did not have an internal audit function. The audit found the four entities with an internal audit function were receiving significant benefits from the activity. The entities had an effective structure to support the internal audit function, were doing the right audits, with the audits well conducted with effective reporting processes.

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<sup>6</sup>The Departments of Education, Health and Communities Tasmania all currently use an internally delivered internal audit function.

<sup>7</sup> Special Report No. 52: Internal Audit - August 2004

- 1.16 In 2018 we conducted a review<sup>8</sup> of audit committees in eight departments and the Tasmanian Health Service<sup>9</sup>. The review covered their composition, operational arrangements and the roles and responsibilities of the audit committee, as documented in the Charter. The review found there was significant room for improvement in the governance arrangements of the audit committees. The recommendations from the report (refer to Appendix 2) focused on updating Treasurer's Instruction TI 108 Internal Audit to require Agencies to strengthen their audit committees' operations. These included ensuring the audit committee had an adequate level of independence and improvements to charters.
- 1.17 A review of the recommendations from 2018 shows they have been partially implemented (refer to Appendix 2). Of the six recommendations that were made to update the Treasurer's Instruction: five were instead included in the Guidelines and one was not implemented at all. Of the four recommendations that were directed to agencies: one was fully implemented, two were partially implemented and one, despite the requirement being removed from the Treasurer's Instruction, had been implemented in all but one agency.

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<sup>8</sup> Auditor-General's Report on the Financial Statements of State Entities (No.9 of 2017-18, Volume 4, June 2018)

<sup>9</sup> Prior to Department of Health and Human Services separating into the Department of Health and Communities Tasmania.



## 2. Are audit committees and internal audit functions effective in providing advice and assurance to the Secretary?

In Chapter 2, we assess whether audit committees and internal audit functions were effective in providing advice and assurance to the Secretary.

Our assessment considered whether:

- there is a common understanding of the advice and assurance needs of the Secretary
- there is effective communication between the Secretary, audit committee and internal audit function
- the audit committee and internal audit function are effective in meeting the needs of the Secretary, including providing value for money.

### Chapter summary

For most departments we found there were effective communication lines between the Secretary and audit committee. Communication was most effective when it was regular and formalised. For four departments, communication was not as strong or effective leading to a poorer understanding of whether the audit committee was meeting the needs of the Secretary and its role in facilitating organisational improvement.

Audit committees and internal audit functions were effective in providing assurance to Secretaries in line with FC-2. However, the provision of advice as to whether departmental performance was supporting strategic objectives and priorities was less developed. It was acknowledged by many we interviewed, this was an area for improvement. We also observed this finding was closely linked to the maturity of the internal audit function, which in several instances, was still operating largely in the compliance area.

A significant barrier contributing to the inability to provide effective advice was a communication disconnect between the audit committee, the Secretary and management. This disconnect negatively impacted on important parts of the internal audit function, including:

- its understanding of the department's strategic objectives and emerging risks
- the internal audit work plan
- clarity around the role of the internal audit stakeholders
- the uptake of recommendations.

Assessing value add provided by the internal audit function was underdeveloped across the departments. There had been progress but much remains to be done to improve

assessments of whether the function is effective and provides value for the work undertaken.

## **Secretaries' expectations and understanding of advice and assurance needs was variable and not supported by strong communication**

- 2.1 The Secretary is responsible for the oversight and management of their department's internal audit function and must ensure the department has an audit committee.<sup>10</sup> This requirement was complied with by all nine departments.
- 2.2 We found, broadly, secretaries received information on internal audit activities directly from the Chair of the audit committee and also from reports submitted by the department's executive. This helped secretaries understand if the internal audit function was meeting their needs and requirements.
- 2.3 We identified inconsistencies in the effectiveness of communication between the Secretary and the Chair of the audit committee. For example, one Chair did not report directly to the Secretary but instead reported to the Secretary's delegate. While there were informal arrangements to report issues, better practice suggests the Chair should have unfettered access to the Secretary. This enables the Chair to effectively communicate the views of the audit committee and outcomes from internal audit work. In another department, where the Chair of the audit committee was a Deputy Secretary, there was no indication the Secretary met with them in their capacity as Chair, only in their substantive role. There is a risk this may prevent the audit committee from understanding the Secretary's expectations for internal audit.
- 2.4 Where communication between the Secretary and audit committee occurred, this was more effective when done in a regular and planned way, including continual feedback and updates on audit reports. This was evident for larger departments where there was a greater amount of audit activity. One Secretary demonstrated a clear understanding of the risks their department must respond to and was involved in providing input into the development of the internal audit work plan thereby ensuring risks were covered. This was as a result of effective regular contact and discussion.
- 2.5 Regular contact also helps facilitate feedback to the audit committee on the value internal audit activities deliver in providing advice and assurance to the Secretary. However, we found it was not always clear this was happening. For example, in one department, we were told the Secretary did not clearly communicate or give direction as to the role and value expected of the audit committee in driving improvement within the department.

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<sup>10</sup> Treasurer's Instruction FC-2 *Internal Audit*

- 2.6 Regular meetings between secretaries and audit committee chairs did not happen in every department. We found six secretaries met with the chairs of their audit committees to discuss internal audit matters. However, the frequency of these meetings varied across departments. For two departments, communication with the Secretary was predominantly through the manager of the internal audit function. For one of these departments, there were no standing meetings with the Chair of the audit committee and improving this relationship was identified as a key area for improvement by the Chair. Irregular meetings with the Chair of the audit committee inhibits communication from the Secretary on their expectations.
- 2.7 Charters generally include guidance on reporting relationships and lines of communication. We found communication between the Secretary, audit committee Chair and internal audit function worked most effectively when arrangements were formalised in charters. This helped set a framework for communication and expectations. For eight departments, the Charter formally detailed expectations on reporting lines for all parties. However, we found for one department, this was not clearly defined.
- 2.8 We identified reporting from the internal audit function to the audit committee, either through contractors or the audit and risk manager, tended to be stronger than with the Secretary. As a result, audit progress and findings were generally communicated well to audit committees. In one department the appointment of an audit and risk manager had significantly improved communication with the audit committee (we discuss this later in this Report).

## **Internal audit functions generally met secretaries' assurance needs but could be more strategically focused**

- 2.9 It is important the internal audit function and the audit committee are effective in providing advice and assurance to the Secretary. We found all departments provided assurance as required under FC-2 which reassured the Secretary their department's internal governance, risk management and control processes were operating effectively. We found secretaries generally understood the assurance requirements of the internal audit function and supported the work carried out in these areas.
- 2.10 An area less well developed within the internal audit function was consideration of key departmental strategic objectives and priorities. For example, one Secretary told us the focus of the internal audit work plan was on assurance, which met their expectations. For another department, we found the audit committee was unclear on their role in identifying areas to be audited, particularly as it related to strategic matters. Underdeveloped risk profiles and registers in departments were also a barrier to implementing a more strategic approach to internal audit. If the internal audit function is largely restricted to providing assurance on the effectiveness of controls

and compliance, this has the potential to limit its performance and opportunity to provide valuable insights and advice on strategic objectives and priorities.

2.11 In our interviews with department staff, many interviewees acknowledged the internal audit function's lack of strategic focus and the need to focus more on strategic organisational risks and priorities. In four departments, we found their internal audit functions were maturing to become more strategic, with projects driving improvements at a more strategic level being considered. This included consideration of the department's strategic plan and a focus on risks. We found one department's internal audit work plan was equally split between assurance and strategic audits at the direction of the Secretary. This demonstrated a clear understanding of the importance of the internal audit function's strategic role and positive steps taken by most departments to support this focus.

## **There was a lack of clarity around how audit committees and internal audit functions demonstrated adding value**

2.12 The overall effectiveness of internal audit in adding value to departments was not clear due to a lack of effective measures and assessment of information. We acknowledge assessing value is not an easy area on which to obtain a clear understanding. Many departments were attempting to determine the value of the internal audit function to their organisation by:

- measuring whether the internal audit work plan was being delivered on time and within budget
- assessing the audit committee's relationship with contractors
- measuring the uptake of internal audit report recommendations
- monitoring the audit committee or internal audit function's capacity to effectively deliver the internal audit work plan
- the audit committee's capacity to follow-up recommendations with business units.

2.13 We found little evidence of departments benchmarking the delivery and impact of audit work and recommendations. Whilst this is not easy to achieve, there is an opportunity for departments to measure and compare internal audit activity and outcome key performance indicators (KPIs) and share initiatives to enhance the internal audit function across departments [refer to the section on performance management later in this Report for further analysis on benchmarking].

2.14 The implementation of recommendations from internal audit work is important for a number of reasons, including enhancing risk management, improving processes and ensuring management accountability for internal control weaknesses or deficiencies. The implementation of recommendations also provides an indication of the

effectiveness of, and value derived from, the audit committee and internal audit function. This was particularly evident for one department which required business unit managers to take responsibility for implementing recommendations. Another department prepared progress reports on the status of recommendations, which ensured they were followed up and addressed. Ultimately, the internal audit function should be measured on the quality of the recommendations, for example, those that encourage organisational improvements in key areas.

- 2.15 Value from the internal audit function can be impeded by a poor relationship between the department and the contractor. In one department, we found the absence of formal feedback, and dissatisfaction with the appropriateness of the contractor's recommendations, limited the internal audit function's ability to meet the Secretary's needs. As a result, the department developed a framework to assess the performance of the contractor, encompassing the quality and timeliness of audit reports and their recommendations.
- 2.16 The audit committee has an important role in developing an effective work plan with the internal audit function and monitoring the impact of internal audit report recommendations with the department's business units. It has a role to play in ensuring the timeliness and quality of audits while understanding and monitoring its independence and ability to provide effective challenge. Audit committees also add value when the Secretary has a clear understanding of how internal audit can help stimulate improvements in the department. One department's audit committee commissioned the contractor to undertake a review of the effectiveness of the audit committee.

### 3. Are secretaries effective in overseeing and managing audit committee and internal audit functions?

In Chapter 3, we consider how Secretaries manage and provide oversight of the activities of the audit committee and internal audit function.

To achieve this, we examined:

- the sufficiency of resources for the audit committees to fulfil their function and purpose
- the authority and access of the audit committee and internal audit functions to undertake their work
- whether audit committees and internal audit functions were subject to performance assessment.

#### Chapter summary

Secretaries' oversight and management of the audit committee and its delivery of internal audit activities were generally effective in stimulating improvements across departments. We found direct resourcing for the audit committee and internal audit function was improving. Most departments were able to find additional resources when emerging risks were identified and needed to be added to the audit work plan. This showed resources were not a limiting factor, even though budgets were largely set on an historical basis. Authority and access was given to the audit committee and the internal audit function ensuring audit work could be undertaken without interference or internal barriers.

We found audit committees were monitoring and following up the progress of audit report recommendations and two departments have established audit and risk manager roles to increase the amount of oversight required to ensure recommendations are implemented.

Notwithstanding these positive findings there are opportunities for improvement in internal audit budget forecasting, resourcing the implementation of recommendations, performance assessment and cultural acceptance of the internal audit function.

## Resourcing of the internal audit function and audit committee was adequate

- 3.1 We found all department audit committees and internal audit functions were sufficiently resourced to undertake their roles, although most departments acknowledged there were constraints to obtaining additional resources. The Chair of one department informed us that while the internal audit budget was supplemented to conduct additional audits, it was insufficient to respond to all the department's high risk areas. Given the budget constraints acknowledged by most departments, it is accepted that not all high risk areas can be covered by internal audit activities. This can be managed by clearly documenting the priorities in the internal audit plan to assist audit committees and internal audit functions understand, and work within, their allocated budgets. Secretaries should produce an assurance map, mapping key risks against, first, second and third line assurance activities to provide confidence that all key strategic and operational risks are covered.
- 3.2 For one department, issues concerning the resourcing of the internal audit function were more acute. We found evidence their budget was often underestimated and, due to budget and time constraints, the audit work plan needed to be reduced with the focus limited to higher risk areas.
- 3.3 In most departments, we found there was no structured approach to setting the internal audit budget, with it largely reflecting historical budget levels. Consequently, internal audit work plans were often set to fit within the budget rather than being decided on a risk-based approach. Despite this finding, most departments reported instances where additional funds had been made available to undertake unplanned audits to address significant known or emerging issues.
- 3.4 Resourcing expectations for the internal audit function were detailed in a few charters. This included ensuring audit committee members had the capacity to undertake their duties together with the provision of secretariat support. There were also mechanisms within charters for the audit committee to report to the Secretary on the sufficiency of resources for the internal audit function. However, it was unclear from our evidence whether this actually occurred.
- 3.5 We found all audit committees had effective processes in place to ensure audit report recommendations were monitored and tracked. This indicated the audit committee understood the importance of, and reported on, implementation of recommendations for improvement. This enables business units to understand the role of the audit committee in overseeing the implementation of recommendations and helps hold business units to account for their implementation.
- 3.6 Most departments had adequate resources to implement recommendations. However, staff responsible for managing the relationship with contractors from two departments reported business unit managers sometimes had difficulties in securing resources when required.

- 3.7 Departments were providing appropriate secretariat support for audit committees. The effectiveness of this support was enhanced when:
- a departmental officer was tasked with providing administrative support, organising audit committee meetings and circulating the agenda and meeting papers to members
  - a senior officer was responsible for liaising between the contractor and the audit committee
  - an audit and risk manager was appointed to provide high level secretariat support and advice to the audit committee and department executive.
- 3.8 In one department we found evidence of internal audit resources being diverted to address operational issues that were the responsibility of business units. This occurred when business units made requests to the audit committee for internal audit activity to address operational issues and the audit committee was reluctant to decline. In our view, this would adversely impact the capacity of the internal audit function to provide advice on strategic performance areas in the department and act independently.

## Formal performance assessment was limited across departments

- 3.9 We found most departments had performance monitoring of the internal audit function specified in the charter but there was little evidence this happened in practice. Where a contractor was used, this was often encompassed in the contractual arrangements but it was not clear whether these expectations were monitored by departments.
- 3.10 Of the three departments with an in-house audit function, only one had a charter which outlined performance expectations, including KPIs, with a review undertaken by the audit committee. The audit committee completed a self-assessment on the internal audit function and also its own performance at the end of 2019 to coincide with the newly appointed Secretary. Although this demonstrated the performance of the internal audit function and audit committee was subject to assessment, no indication was provided as to whether assessments were conducted regularly.
- 3.11 For the six departments that outsourced the internal audit function to a contractor, formal performance assessment was limited, but where it occurred, it was primarily in the form of self-assessment. For example, we found one department's audit committee Chair met with the contractor on an annual basis to discuss a self-assessment completed on contractor performance. The Chair also assessed the contractor's performance against the contract and whether audits met the expected plan, scope, budget and timeline. Conversely, in another department, we found KPIs under the contract were not reviewed, indicating the absence of any formal assessment of the internal audit work plan and the performance of contractors. It is



important audit committees implement appropriate mechanisms to monitor and assess the performance of contractors.

3.12 In examining recent changes in contractor appointments, we identified the duration of contractor appointment provided the opportunity for audit committees to manage contractor underperformance through the selection of new contractor, rather than rely on contractual performance provisions. We identified two instances where audit committees had changed contractors due to poor performance through a request for tender process. In another instance the audit committee appointed a new contractor, not because of performance issues, but because they wanted to refresh the independence of the internal audit function.

3.13 There was a common theme in our interviews with departmental staff regarding performance assessment management of audit committees. Most departments did not undertake any formal performance review of audit committees, but a few audit committees had conducted self-assessments. For example, one department's audit committee provided feedback on their performance through a survey which covered:

- audit committee members' understanding of their roles
- audit committee member skills and areas for improvement
- overall effectiveness of the internal audit function
- audit committee members' response to significant risks.

Annual self-assessments are important in helping the audit committee identify and resolve issues and improve overall performance.

## Acceptance of the internal audit role was generally supported

3.14 All audit committees and internal audit functions had sufficient authority and access to effectively undertake audit activities. This meant having unrestricted access to information, documents and departmental personnel. Charters outlined how access must be provided for the audit committee and internal audit function, respectively.

3.15 Where this worked effectively in practice, there was strong cooperation from staff and broad support for internal audit across the department, including the executive. In one department, business unit managers were supportive of internal audit's role in managing risks and recognised its value in driving improvements. This was important as it enabled the internal audit function to deliver its work unrestricted and demonstrated a risk-based culture across the department. In another department, there was a broadly positive response to the internal audit function from management, although some business units saw internal audit as the first line of defence. This may shift accountability for risk management from the business unit manager to the internal audit function.

- 3.16 In contrast to a broadly positive response to the internal audit function, for one department there was evidence of negative reactions to audit findings and management resistance to implement recommendations. This suggested the cultural acceptance of internal audit could be improved. The audit committee secretariat identified this as an area for improvement and highlighted communication of the importance of the internal audit function as a means of improving cultural acceptance.
- 3.17 We also found the induction process for contractors in this department was insufficient. The lack of a proper induction limited the contractor's capacity to understand the department's culture and perform effectively. In addition, poor communication and support for the contractor significantly hindered the quality and timeliness of audit work.

## 4. Do audit committees effectively provide objective challenge and assurance?

In this Chapter, we evaluate whether audit committees effectively deliver objective challenge and assurance.

To do this, we examined whether:

- audit committees had the right skills and capability to function effectively
- audit committee members had sufficient independence from the department
- audit committees had a clearly defined function, purpose and responsibility covering governance, risk management and control processes.

### Chapter summary

Overall, audit committees delivered challenge and assurance but objectivity was compromised as a consequence of audit committee composition being heavily weighted towards internal membership. Only two out of nine audit committees had a majority of independent members.

There were differing views from departments on how independence was achieved and there was no formalised process for determining the appropriate skills mix on the audit committee. A few departments were resistant to independent audit committee membership due to a perception these members had limited departmental knowledge and could not provide effective challenge. These and other justifications for not increasing the level of independence were limited and did not reflect good practice. In contrast, two departments recognised the need to increase independence and had either recruited additional members or were undertaking a review of the audit committee's composition. An audit committee comprised entirely of internal members limits the actual and perceived ability of the audit committee to effectively challenge departmental management.

All departments had a charter which defined the audit committee's function, purpose and responsibility and most members indicated this supported them in undertaking their roles. However, there was a need for most departments to provide their audit committees with formal induction and training. This would provide audit committee members with a better understanding of their responsibilities.

## Audit committees did not formally identify skills needed for members

- 4.1 FC-2 states the audit committee must comprise at least three persons that have appropriate qualifications, knowledge, skills or experience to enable the audit committee to perform its functions.<sup>11</sup> All departments met the requirement to have at least three persons as required under FC-2. In addition, all charters provided instruction on membership requirements for audit committees.
- 4.2 Most charters specified a requirement for at least one member of the audit committee to have financial skills together with guidance around representation across business units. However, we found the skills required for an effective audit committee had not been defined or formalised in a skills matrix or role profile. Requisite skills would generally encompass accounting, audit, legal, information technology, risk management, governance, public policy and skills specific to the department.
- 4.3 All departments had documented requirements relating to the composition of their audit committee and this varied depending on the operational requirements and size of departments. All audit committees had, to varying degrees, members with knowledge of the department, including the department's goals, functions and challenges, and financial reporting requirements. Three audit committee Chairs identified the need for members with stronger financial skills. In one department, the skill requirements were largely driven by the Secretary, with the audit committee Chair having strong financial skills, which was viewed as a prerequisite skill for an independent member.

## Audit committee membership was too heavily weighted towards internal representation

- 4.4 *Report of the Auditor-General No. 9 of 2017-18* recommended the precursor of FC-2 be amended to ensure the composition of the audit committee supported an adequate level of independence, with:
  - the appointment of an external Chair
  - the majority of members being independent/external
  - a regular rotation of audit committee membership.

Whilst Treasury did not mandate any independence requirements in FC-2 in response to the recommendation, information was included in the Guidelines to assist compliance with FC-2. The Guidelines recommend secretaries appoint audit committee members who exhibit an independence of mind and who do not act as

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<sup>11</sup> The Treasurer's Instruction FC-2 *Internal Audit*

representatives of a particular area within the department or a particular stakeholder interest, and have policies in place to identify changing relationships or circumstances that may affect the independence of audit committee members.

- 4.5 There is general acknowledgement that audit committee members must have an understanding of the whole department so as to help improve the department’s overall governance, risk management and control processes. From our review of charters and interviews with audit committee members we identified that representation of business units across the department on the audit committee was also viewed as important. However, in examining the composition of audit committees for all departments, we identified two departments had predominantly based the audit committee composition on business unit representation rather than skill requirements.
- 4.6 We found the audit committees of five departments had majority internal members. These departments provided justification for higher levels of internal membership on their audit committees. These justifications, together with our response are shown in Table 1 below.

Table 1: Justification for higher levels of internal membership on audit committees

Department justification	Tasmanian Audit Office response
Corporate knowledge was considered to be more important than independence	Providing formal induction would overcome this as it would develop external member knowledge of the department
External members had limited understanding of the department’s operations	Providing formal induction would overcome this as it would develop external member knowledge of the department
Cost associated with appointing an external member	Costs would not be excessive
An internal Chair had more credibility and support from within the department	Appointing an external Chair with senior public sector experience would overcome this and there were examples where this arrangement benefited other departments
Internal audit committee members would be reluctant to discuss sensitive issues with external members present	Overcome by external members being bound by confidentiality and, in fact, a greater issue for internal members due to their inherent conflicts of interest.
Lack of independence could be mitigated by managing conflicts of interest at audit committee meetings, providing a standing invitation to Tasmanian Audit Office staff to attend meetings, and including members from a diverse range of business units.	A majority of independent external members will lessen, but not remove, the need to declare and manage conflict of interests. The Tasmanian Audit Office does not attend all meetings, or for entire meetings, so this does not mitigate the lack of audit committee independence.

- 4.7 Department justifications to have audit committees with a majority of internal members do not provide an effective balance of viewpoints around capacity and capability to provide objective challenge when necessary. Further, external members would provide the audit committee with a fresh perspective on the department's operations and would be able to share audit committee and internal audit function insights from other relevant experience.
- 4.8 In our view, there has been an over-reliance on internal representation on audit committees with less focus on key skills and expertise to ensure an effective audit committee. We raised this previously in *Report of the Auditor-General No.9 of 2017-18* and recommended the composition of the audit committee include a majority of independent external members. Having a majority of independent external members will ensure audit committees can provide objective challenge and help address conflict of interests which invariably arise for audit committees with internal members who hold management positions.

## **The audit committee's independence and objective challenge would be enhanced by having an external Chair**

- 4.9 Despite the *Report of the Auditor-General No. 9 of 2017-18* recommendation for audit committees to appoint an external Chair, the audit committees for five departments were chaired by internal members. In one department, the audit committee Chair was always appointed from the corporate services division. The view of this department, was this provided greater oversight of risks across the department. In another department, three out of five members of the department executive sat on the audit committee with the Chair being the Deputy Secretary responsible for corporate services. With such a high level of involvement from the department's executive, the audit committee's capacity to provide objective challenge was limited. We were informed the audit committee was aware of these issues and tried to mitigate them through clear delineation of responsibilities between being both a member of the executive and audit committee member. In our view this does not effectively mitigate the lack of independence.

## **Formal induction was lacking or not provided to new audit committee members**

- 4.10 Regularly renewing the membership of the audit committee can provide renewed focus to internal audit activities. While rotational membership did occur for internal members, the evidence was unclear on whether this was undertaken regularly. One department's charter noted the appointment terms for members was entirely at the Secretary's discretion. Contracts for external members should be reviewed periodically, for example every three years, to ensure independent members are refreshed.

4.11 We found formal induction for new audit committee members was lacking or not provided at all in most departments. In contrast, one department provided thorough induction and training for both internal and external audit committee members. They had a comprehensive induction manual which outlined the purpose and function of the audit committee. The manual detailed the mechanisms by which audit committee members would be subject to performance assessment through the completion of a questionnaire. In addition, a number of standard documents were provided to audit committee members, including the internal audit work plan, business and corporate priority documents and charter. We consider this to be good practice but did not find evidence other departments provided similar support to new audit committee members.

## Charters generally followed Treasury guidelines

4.12 Charters specify how internal audit functions and audit committees fulfil their roles and responsibilities and set expectations for the delivery of the internal audit work plan. All departments had a charter as required under FC-2, but three were not regularly reviewed. All charters adequately defined the function, purpose, authority and responsibility of the audit committee, and promoted a clearer understanding of the role of internal audit to audit committee members and more widely across the department. However, one department's charter did not mention the authority of the audit committee. We found there was uncertainty in three audit committees of members' responsibilities and whether activities should be focused on compliance, assurance or advice. In one department, this resulted in management challenging the audit committee's authority and responsibility which significantly impacted its effectiveness. The secretary must approve the charter as required under FC-2 which was specified for seven departments but was not evident for the other two. A charter should clearly specify whether it was approved by the secretary and the date of approval.

4.13 The Guidelines contain further information in support of FC-2 about what internal audit charters should define. The Guidelines state that the charter should:<sup>12</sup>

- identify the function, purpose, authority and responsibility of the internal auditor
- establish the internal auditor's independence within the organisational structure
- define reporting relationships of the internal auditor with the secretary and the audit committee
- define the internal auditor's relationship with the Auditor-General
- define the scope of the internal auditor's activities, including any restrictions, together with the reasons for such restrictions.

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<sup>12</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, page 7

- 4.14 Charters for five departments fully met the above requirements for better practice. Charters for two departments met most of the requirements but needed to include further information on reporting relationships as this was unclear. For the other two departments there was no mention of the independence of the internal audit function within the charters. However, they met all the other requirements.
- 4.15 *Report of the Auditor-General No. 9 of 2017-18* recommended an audit committee should review and, where necessary, update their charter annually. The requirement to annually review the charter is included in the Guidelines. We found six out of nine charters included clear instructions for the charter to be reviewed annually. However, the review date was not always reflected in the document. One charter did not specify the review date and the other two included review periods of two or three years.
- 4.16 *Report of the Auditor-General No. 9 of 2017-18* also recommended charters be more specific on the audit committee's role in reviewing financial reporting responsibilities. This was reflected in the Guidelines and we found all charters had assurances relating to the audit committee's oversight of financial reporting. This practice involved the preparation of financial statements and inclusion of audit financial statements in the annual report.
- 4.17 All charters provided information on membership requirements specific to their department. Most charters documented the need for the audit committee to include either members with certain skills from a particular business unit or by nomination from a deputy secretary. Only three departments specified better practice for majority independent membership, an external Chair and rotational membership in their charter. While rotating members may happen in practice, this was not evident in the charters we reviewed.
- 4.18 Charters contained varying levels of information on the audit committee's function, purpose and responsibilities. While most audit committees reported their charter met their needs, the charters for four departments could have been improved by adopting the good practice referenced in the Guidelines.



## 5. Are internal audit functions effective in strengthening departmental governance, risk management and control processes?

In Chapter 5 we assess whether internal audit functions were effective in strengthening departments' internal governance, risk management and control processes.

To achieve this, we examined whether:

- internal audit work plans considered departmental objectives, priorities and risks and encompassed governance, risk management and control processes
- internal audit work plans were subject to periodic review and approval.

### Chapter summary

Not all department internal audit work plans were clearly linked to strategic risks, objectives and priorities. This was more acute where departments had not updated, or were developing, their approach to risk management. A few departments outlined the internal audit function was still developing and had not reached a point where more strategic internal audit work could be regularly considered.

However, across departments, internal audit functions were largely effective in strengthening internal governance, risk management and control processes. Plans were regularly reviewed to incorporate new projects and address emerging risks.

### For most internal audit work plans, the link between strategic objectives, and priorities required greater clarity

- 5.1 All internal audit work plans were prepared to provide assurance, with consideration given to internal governance, risk management and control processes, with risk a significant focus. This included reducing the incidence of fraud. This view was supported by the views of departmental staff and audit committee members. However, there was an acknowledgment from many interviewees of the need to provide a stronger linkage with departmental objectives and priorities. This view was particularly strong from audit committee members. All departments were at different stages in realising this aim with few acknowledging their work plan only focused on providing assurance.
- 5.2 Two departments were more advanced in revising their internal audit work plans, with a more strategic focus with the provision of a higher level of advice. We found one department gave equal consideration to assurance and advice which was specified

within the contract with their contractor. Another department's internal audit manager was responsible for managing the risk framework and as a result the internal audit work plan had a significant risk focus. This approach ensured the internal audit function was working to address areas that presented a significant risk to the achievement of the department's objectives as well as areas of underperformance.

- 5.3 Clear linkages between risk management and strategic plans enhance the quality and coverage of internal audit plans. However, this was not always apparent in the work plans we reviewed. We found there was a perception from many interviewees their internal audit work plans were closely aligned to the department's risks and strategic objectives. However, for most departments, we found risk documentation was not detailed enough to have effective input into the development of the internal audit work plan. We were unable to see clear linkages between risk management, strategic planning and the development of all the work plans we reviewed. While risks were often considered in work plans, there was no clear 'line of sight' between risk and internal audit work plans and we were unable to gain a clear indication of whether key departmental risks and strategic objectives were being routinely considered.
- 5.4 For three departments, we found internal audit work plans were developed in a partnership arrangement between the Chair of the audit committee and the internal audit function. While it was important the audit committee Chair exerted a degree of influence on the work plan, consultation on the plan with other stakeholders varied. In some instances, audit committee members and senior managers were not consulted on the work plan. This lack of engagement could limit the development of the plan, 'buy in' and commitment from the audit committee and more widely across the department.
- 5.5 The level of secretary involvement in the development of the internal audit work plan also varied. A few departments had strong engagement regarding planning with their Secretary and department executive. For others there was less engagement. One Secretary informed us they did not want to provide input into the work plan as this would compromise the independence of the internal audit function. However, this could also lead to a lack of direction and vital input into the audit committee. While the independence of the function should not be compromised, key stakeholders in departments should consider how best to ensure work plans are appropriately communicated to and considered by Secretaries and members of the departmental executive.
- 5.6 We found evidence of internal audit functions becoming more mature, with greater focus on addressing strategic objectives and priorities. A few departments were further along this pathway than others, with most acknowledging this as a key area for improvement.

## Internal audit work plans were subject to regular review

- 5.7 FC-2 requires the audit committee to review and approve the internal audit work plan and we found this occurred on an annual basis.
- 5.8 Work plans should be agile and able to plan ahead for future activity. Good practice indicates having a rolling three year work plan that is reviewed regularly and supports effective internal audit activity. We found four departments had an audit plan that covered the current financial year, with another department updating their plan on a quarterly basis. Four departments had a three-year audit work plan but these were reviewed annually to adapt to changing circumstances. This was commonly identified as necessary to ensure the work plan remained relevant and not restricted to set audit activity. This demonstrated audit committees were thinking strategically and anticipating issues.
- 5.9 We found most audit committees had flexibility to review and amend internal audit work plans to undertake unplanned audits and address emerging risks. Cyber security was an example of one such risk often cited in our interviews. One Secretary referred to the department's work plan as a 'living document' that he reviewed quarterly with the audit committee Chair to ensure it was relevant. Having this agility ensured internal audit work plans were fit for purpose and responsive to issues as they arose.

# Acronyms and abbreviations

ARMC	Audit and Risk Management Committee
Audit Act	<i>Audit Act 2008</i>
Contractors	Contracted internal audit service providers
Departments	Tasmanian Government Departments
DoE	Department of Education
DPAC	Department of Premier and Cabinet
DPFEM	Department of Police, Fire and Emergency Management
FC-2	Treasurer's Instructions FC 2 <i>Internal Audit</i>
Guidelines	<i>Financial Management – Better Practice Guidelines</i>
IIA	Institute of Internal Auditors
KPI	Key Performance Indicators
RiMAC	Risk Management and Audit Committee
Treasury	Department of Treasury and Finance

# Appendix 1: Internal audit checklist of good practice

Based on our audit activity, this appendix provides a checklist of the good practice we found.

The Secretary is active in ensuring their advice and assurance needs are communicated and understood. This includes providing feedback on the audit functions activities and attending audit committee meetings.
The reporting relationships between the Secretary, audit committee and internal auditors are clear and formalised.
The Secretary regularly meets and communicates directly with the Chair of the audit committee.
Audit committees are subject to formal performance assessment by the Secretary.
Audit committees have a register of audit recommendations and regularly follow up progress with the responsible manager.
Audit committees have a skills matrix or similar which describes the required skills of members.
Audit committee members are trained and inducted into the department and made aware of the context, risks and priorities. This training should be undertaken annually and cover independence and managing conflicts of interest.
The audit committee invites risk owners and managers to discuss areas of risk at its meetings.
Internal auditors are given unrestricted access to all areas of the department.
Internal auditors (both in-house and contractors) are subject to performance assessment which includes reviews of timeliness, reporting, scope, budget and communication.
Internal audit contractors are inducted into the department and made aware of key areas of risk, priority and objectives; and introduced to key people in the department.
Internal audit contracts detail expectations and include agreed objectives and KPIs.
The audit committee Chair is independent of the organisation.
The audit committee has a Deputy Chair to discuss matters directly with the internal audit function if the Chair has a conflict of interest.

The audit committee contains majority independent members.
The audit committee charter allows the Chair free and unrestricted access to the Secretary.
The budget for internal audit activities is set on a needs basis and allows coverage of the departmental key risk areas.
The charter clearly defines the function, purpose and responsibility of the audit committee.
The charter clearly defines the responsibilities and reporting relationships of the internal auditors.
The internal audit work plan is developed with input from risk owners and managers who can identify areas of risk in their business units.
Internal audit work plans are developed with departmental key risks, objectives and priorities in mind.
Audit committees and audit and risk managers have high level of oversight and input into the audit work plan. The audit committee has final approval of the plan.
Internal audit plans are flexible and can change to account for emerging risks.
Internal audit plans include an assurance map which compares audit activities with the department's key risks, objectives and priorities.
The Secretary and audit committee should include benchmarking on timeliness, quality and impact of audit report recommendations.

# Appendix 2: Recommendations from the Auditor-General’s Report on the Financial Statements of State Entities (No.9 of 2017-18, Volume 4)

## Recommendation 1

The Treasurer’s Instruction is amended to ensure the composition of the audit committee supports an adequate level of independence to meet the required functions. The required composition should include:

- the appointment of an external Chair
- the majority of members are independent/external
- regular rotation of audit committee membership.

### Recommendation follow-up

This recommendation has been partially implemented. The Treasurer’s Instruction was not amended but the following has been included in the Guidelines:

*In addition to the requirements of the Treasurer’s Instruction, the Accountable Authority should consider the independence of Audit Committee members. The Auditor-General’s 2018 review of Agency Audit Committees (the Report of the Auditor-General No 9 of 2017-18, Volume 4 refers), recommended that Audit Committees may consider:*

- *the appointment of an external Chair;*
- *the majority of members are independent/external; and*
- *regular rotation of Audit Committee membership<sup>13</sup>.*

## Recommendation 2

The Treasurer’s Instruction is amended to include the following requirements:

- Audit committee charters are reviewed and, where necessary, updated on an annual basis
- Audit committee’s commission an annual assurance map.

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<sup>13</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, page 6

### Recommendation follow-up

This recommendation has been partially implemented. The Treasurer's Instruction was not amended but the following has been included in the Guidelines in regards to charters:

*The Audit Committee should annually review the Internal Audit Charter to ensure that it remains up-to-date and reflects the current function, purpose, authority and responsibility of those undertaking the internal audit function<sup>14</sup>*

and assurance maps:

*The Accountable Authority should consider the establishment of an assurance map to help assist with its management responsibilities. An Agency will typically have a variety of assurance mechanisms and arrangements including the control framework, internal audit and external audit. An Agency-wide perspective of assurance activities can help the Audit Committee identify gaps or duplication. It can also help identify key risks that are not being addressed by any assurance activities<sup>15</sup>.*

### Recommendation 3

Audit committee charters are amended to include the following roles and responsibilities in relation to engagement with external audit:

- have a members-only meeting with the TAO at least once per year so that the committee can obtain the views of the TAO without internal audit or management being present
- periodically review the performance of external audit, and report the results to the Secretary.

### Recommendation follow-up

This recommendation has been fully implemented by three agencies, partially implemented by five and not implemented by one.

In the five agencies who partially implemented the recommendation the charter included reviewing the performance of external audit but not a members-only meeting with the TAO at least once per year.

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<sup>14</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, page 7

<sup>15</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, page 8



## Recommendation 4

The Treasurer's Instruction is amended to include reviewing the financial reporting responsibilities and financial report as a role in the audit committee's oversight function.

Audit committee charters are more specific on the role of the audit committee in reviewing financial reporting responsibilities and the financial report.

### Recommendation follow-up

This recommendation has been partially implemented by Treasury. The Treasurer's Instruction was not amended but the following has been included in the Guidelines:

*It is an important role of Audit Committees to review the financial reporting responsibilities of the Accountable Authority and advise the Accountable Authority on the results of the review. The primary financial reporting responsibilities consist of the preparation of annual financial statements and the inclusion of the audited financial statements in the Annual Report. The Audit Committee should consider the following:*

- *review the financial statements and provide advice to the Accountable Authority (including recommending their signing by the Accountable Authority);*
- *ensure compliance with Accounting Standards;*
- *review the appropriateness of accounting policies and disclosures, including any significant changes to accounting policies;*
- *review areas of significant judgement and financial statement balances that require estimation;*
- *review significant or unusual transactions; and*
- *ensure appropriate management action has been taken in response to any issues raised by external audit, including financial statement adjustments or revised disclosures<sup>16</sup>.*

In charters, detail on financial reporting oversight has been fully implemented across all agencies.

## Recommendation 5

The Treasurer's Instruction is amended to include reviewing performance reporting responsibilities and as a role in the audit committee's oversight function.

Audit committee charters include the oversight of performance reporting as part of their roles and responsibilities.

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<sup>16</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, page 9

### Recommendation follow-up

This recommendation has not been implemented by Treasury, neither the Treasurer's Instruction nor the Guidelines have been updated.

In charters, oversight of performance reporting has been included by four agencies.

### Recommendation 6

The Treasurer's Instruction is amended to include the oversight of the Agency's risk management function as a responsibility and as a role of the audit committee.

### Recommendation follow-up

This recommendation has not been implemented.

At the time of the 2018 audit the Treasurer's Instruction TT 108 read:

*(15) The scope of services provided by the internal auditor will include: (a) the examination and evaluation of the adequacy and effectiveness of the Agency's systems of internal control, risk management and governance<sup>17</sup>.*

The current Treasurer's Instruction FC-2 reads:

*2.3 The internal audit function must provide for the ongoing review of the effectiveness of internal governance, risk management and control processes in the Agency<sup>18</sup>.*

### Recommendation 7

Audit committee charters include the oversight of the Agency's responsibility to manage the exposure to fraud risk in order to ensure that the audit committee complies with the Treasurer's Instruction.

### Recommendation follow-up

At the time of the 2018 audit the Treasurer's Instruction TT 108 included 'ensure appropriate management of the Agency's exposure to fraud risk' in the oversight function of the audit committee but the same is not included in FC-2. The Guidelines only mention fraud in relation to allocating specialist functions to some members; a Fraud Control Officer is given as an example.

Despite this, oversight of fraud risk is detailed in eight of the nine agency charters.

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<sup>17</sup> Withdrawn Treasurer's Instruction TT108 *Internal Audit*

<sup>18</sup> Treasurer's Instruction FC-2 *Internal Audit*

## Recommendation 8

It is recommended that the Treasurer's Instruction expands the oversight functions of the Audit Committee around the system of internal control to include:

- oversight of the Agency's system of internal control in order to ensure that the Audit Committee complies with the Treasurer's Instruction
- oversight of the Agency's systems for monitoring legislative and policy compliance
- promotion of ethical and lawful conduct
- obtaining and annual report from Internal Audit on the overall controls of the Agency
- business continuity management
- delegations
- ethical and lawful conduct.

### Recommendation follow-up

This recommendation has been partially implemented. The Treasurer's Instruction was not amended but the following has been included in the Guidelines:

*As part of the internal control environment, the Agency is expected to have well designed business continuity and disaster recovery arrangements and the Audit Committee should satisfy itself that these arrangements are in place and that existing business continuity and disaster recovery plans have been periodically updated and tested.*

*The Auditor-General's 2018 review of Agency Audit Committees (the Report of the Auditor-General No 9 of 2017-18, Volume 4 refers) recommended that the Audit Committee's oversight of the system of internal controls may include:*

- *ensuring the Agency's system of internal control complies with the Treasurer's Instructions;*
- *review of the Agency's systems for monitoring legislative and policy compliance;*
- *obtaining an annual report from Internal Audit on the overall controls of the Agency;*
- *business continuity management; and*
- *promotion of ethical and lawful conduct<sup>19</sup>.*

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<sup>19</sup> *Financial Management – Better Practice Guidelines*, Department of Treasury and Finance, 2016, pages 9-10



# Audit Mandate and Standards Applied

## Mandate

Section 23 of the *Audit Act 2008* states that:

- (1) The Auditor-General may at any time carry out an examination or investigation for one or more of the following purposes:
  - (a) examining the accounting and financial management information systems of the Treasurer, a State entity or a subsidiary of a State entity to determine their effectiveness in achieving or monitoring program results;
  - (b) investigating any matter relating to the accounts of the Treasurer, a State entity or a subsidiary of a State entity;
  - (c) investigating any matter relating to public money or other money, or to public property or other property;
  - (d) examining the compliance of a State entity or a subsidiary of a State entity with written laws or its own internal policies;
  - (e) examining the efficiency, effectiveness and economy of a State entity, a number of State entities, a part of a State entity or a subsidiary of a State entity;
  - (f) examining the efficiency, effectiveness and economy with which a related entity of a State entity performs functions –
    - (i) on behalf of the State entity; or
    - (ii) in partnership or jointly with the State entity; or
    - (iii) as the delegate or agent of the State entity;
  - (g) examining the performance and exercise of the Employer's functions and powers under the *State Service Act 2000*.
- (2) Any examination or investigation carried out by the Auditor-General under subsection (1) is to be carried out in accordance with the powers of this Act

## Standards Applied

Section 31 specifies that:

'The Auditor-General is to perform the audits required by this or any other Act in such a manner as the Auditor-General thinks fit having regard to -

- (a) the character and effectiveness of the internal control and internal audit of the relevant State entity or audited subsidiary of a State entity; and
- (b) the Australian Auditing and Assurance Standards.'

The auditing standards referred to are Australian Auditing Standards as issued by the Australian Auditing and Assurance Standards Board.



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