

23 October 2019

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
PO Box 6100
Parliament House
CANBERRA, ACT 2600

Dear Committee Secretary,

RE: REGULATION OF AUDITING IN AUSTRALIA

Introduction

The Institute of Internal Auditors – Australia (IIA-Australia) makes this public submission specifically in response to section 10 of the Terms of Reference of the Parliamentary Joint Committee on Corporations and Financial Services – Regulation of Auditing in Australia, ‘the adequacy and performance of regulatory, standards, disciplinary and other bodies’, and section 12 ‘any other matter’, in relation to the impact on the internal audit profession, and consequently on the quality and reliability of the external audit process itself.

In this submission, we will outline what we believe are weaknesses and inconsistencies in standards and definitions, and the regulatory framework that impacts on the audit process and the internal audit profession.

IIA-Australia recommends that the Parliamentary Joint Committee should address these weaknesses and inconsistencies in its final report, which would consequently improve the governance structures within private and public sector entities, and the quality of external audit reporting.

IIA-Australia understands the primary focus of the Committee will be on external auditors and their audit role, however, that is only one aspect of the governance structure, and the Committee should consider the wider implications of the constraints imposed by inadequate and inconsistent standards and legislative frameworks. To assist the Committee’s understanding in this regard, at the end of this submission we have outlined the key definitional differences between external audit and internal audit.

We will argue that the current inconsistencies impact on the role of the external auditor in their interactions with other assurance providers such as internal auditors.

These omissions in auditing and prudential standards can easily be remedied, and IIA-Australia has made some simple recommendations for the Parliamentary Joint Committee to consider.

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1. Standards

Members of IIA-Australia sign a declaration that they will follow the *International Standards for the Profession and Practice of Internal Auditing* (the *Standards*). These are the only *Standards* that exist in Australia that are relevant and applicable to the profession of internal auditing. However, many internal auditors do not conform to the *Standards*. Not conforming to professional *Standards* threatens the quality of internal audit work, not to mention the reputation of the profession.

In contrast, the Auditing and Assurance Standards Board (AUASB) develops mandatory standards for the conduct of and reporting on external audit and assurance engagements in Australia.

The AUASB is a Non-Corporate Commonwealth Entity established under section 227A of the *Australian Securities and Investments Commission Act 2001*, as amended (ASIC Act).

The scope of the external auditor's engagement emanates from the requirements under the *Corporations Act 2001* and other relevant legislation, to audit and review the entity's financial report. Internal audit, on the other hand, provides assurance that the controls in place across a business are sufficient to manage risk, and that governance processes are adequate and organizational objectives are met.

The AUASB has, since its formation following the HIH scandal, developed auditing standards primarily for external auditors, or external auditors working with other assurance providers such as internal auditors (ASA 610 *Using the work of Internal Auditors*). The intention of policy makers at the time was to broaden powers to include not only external auditors, but other assurance providers. This was debated in Federal parliament at the time.

Under section 336 (3) of the *Corporations Act 2001* the AUASB may make auditing standards in relation to financial reports.

However, the power to make auditing standards on assurance matters is clearer for the AUASB under section 227B *Australian Securities and Investments Act 2001*. It is outlined that functions under section 336 of the *Corporations Act 2001* for the purposes of the Corporations legislation and under (1) (b) is "to formulate auditing and assurance standards for other purposes; and (c) to formulate guidance on auditing and assurance matters."

2. Different definitions

ASA 610 *Using the Work of Internal Auditors* was issued at the same time as ASA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*. The scope of ASA 315 "deals with the auditor's responsibility to identify and assess the risks of material misstatement in the financial report, through understanding the entity and its environment, including the entity's internal control."

There are two basic reasons why it is necessary to clearly define the position of internal auditors.

The first is to provide ASIC and APRA with detailed guidance/boundaries so they would know precisely what they would be required to supervise as part of their regulatory function.

The second reason is because there is no clarity in current regulations. For example, there are a number of assurance providers such as risk managers who will also claim to be undertaking the same services.

Under ASA 610 the definition of an Internal Audit Function states: "The objectives and scope of internal audit functions typically include assurance and consulting activities designed to evaluate and improve effectiveness of the entity's governance processes, risk management and internal control."

This standard (ASA 610) also states that activities similar to those performed by an internal audit function may be conducted by functions with other titles within an entity or outsourced to a third-party provider such as an assurance practitioner.

To qualify exactly what constitutes the relationship with the internal auditor and the work performed is stated in the Application and Other Explanatory Material supporting ASA 315, section A9 *Enquiries of the Internal Audit Function* "If an entity has an internal audit function, enquiries of the appropriate individuals within the function may provide information that is useful to the auditor in obtaining an understanding of the entity and its environment, and in identifying and assessing risks of material misstatement at the financial statement and assertion levels".

More specifically in A12 "Appropriate individuals within the internal audit function with whom enquiries are made are those who, in the auditor's judgement, have the appropriate knowledge, experience and authority, such as the internal audit executive or, depending on the circumstances, other personnel within the function".

Our view is that the external auditor must not solely rely on their "judgement" but should make enquiries as to the "knowledge and experience" of the internal auditor as stated in ASA 610 A 8. The standard, which is a legislative instrument and has the force of law, should clarify what "professional designation and experience" is acceptable, and whether the internal auditor is a member of "professional bodies", and follows "applicable professional standards".

However, we believe there is a simple solution to this issue that would assist external auditors relying on the work of internal auditors, and at the same time ensure internal auditors are following the prescribed *Standard*.

On a practical note, external auditors exercising their 'judgement' could easily be supported in AUASB issued standards by:

- a. including reference to the *International Standards for the Professional Practice of Internal Auditing* (the *Standards*) as a footnote to ASA 610 to guide the external auditor to confirm that the internal audit function does follow the accepted global *Standards* upon which they have relied, and
- b. that the internal auditor is 'suitably qualified' to undertake that role or alternately separate guidance material in support of ASA 315.

This would give the external auditor some comfort in relying on advice that is from a 'suitably qualified' internal audit practitioner, not simply an 'assurance practitioner', and secondly, reduce any legal liability.

On the matter of qualifications, again a footnote or inclusion supporting Prudential Standards, or in separate guidance material, should be adequate to satisfy the qualification requirements.

For example, and in direct contrast to ASA 610, in ASA 620 *Using the Work of an Expert* issued by AUASB (April 2006) at paragraph 12 "When planning to use the work of an expert, the auditor shall evaluate the professional competence of the expert by (at paragraph 13) consider the expert's (a) professional certification or licensing by, or membership in, an appropriate professional body" (Page 9).

These matters are simple to correct and would result in better governance practices. For example, we recommend amending current standards and guidance materials with:

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- a. If an entity has an internal audit function, it must follow the International Professional Practices Framework (IPPF) containing the *International Standards for the Professional Practice of Internal Auditing*.
- b. If an entity has an internal audit function, the head of that function should be 'suitably qualified' or have immediate access to someone who is, and ideally have a direct reporting line to the board or to the board audit committee to bring the requisite degree of independence and objectivity to the role.
- c. The Internal Auditor should be a member of The Institute of Internal Auditors-Australia – the professional association representing the profession of internal auditing.

Qualifications and suitable experience for an internal auditor is demonstrated by being a Certified Internal Auditor® (CIA®) or in Australia having graduated with the post-graduate Graduate Certificate in Internal Auditing qualification or having been appointed a Professional Member of the Institute Internal Auditors (with the PMIIA post-nominal).

It is IIA-Australia's view that the institutional environment has changed dramatically in the last decade with internal auditing becoming more prominent in the governance of private and public sector organizations. Therefore, it would prudent of regulators to ensure that external auditors' reliance on internal audit practitioners follow updated and correct procedure.

3. Prudential Standards

APRA Prudential Standard CPS 510 *Governance* does include a requirement for an internal audit function, but also allows exemptions, and it also states the "alternative arrangements for an institution where APRA is satisfied that they will achieve the same objective." It is not clear what "alternative" arrangements the regulator would consider in place of an effective internal audit function.

APRA Prudential Standard 510 at paragraph 88 states "an internal auditor must have a reporting line and unfettered access to the Board Audit Committee", and at 91 "to fulfill its functions, the internal auditor must, at all times, have unfettered access to the institution's business lines and support functions." However, the internal auditor, in contrast to the external auditor, has no regulatory or legislative powers to support enforcing their rights to information within a business.

Furthermore, there is no reference to internal auditors following the *International Standards for the Professional Practice of Internal Auditing*. This contrasts with external auditors that must comply with the *Corporations Act 2001* and to AUASB issued standards.

4. Other Guidance material

ASIC Information Sheet 221 states that internal audit should be independent from management, and "should report directly to the audit committee rather than management."

However, internal audit will be expected to have a close relationship with and 'administratively' report to senior management (preferably the Chief Executive). Safeguards need to be in place because the head of internal audit could be removed, placed under duress, censored or have their scope and resources reduced by management. There are limited protections for the head of internal audit.

There is a symbiotic relationship between the audit committee and internal audit. A strong working relationship with the audit committee is vital if internal audit is to perform its role effectively. It also allows the audit committee to drive internal audit in meeting its expectations.

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APRA Prudential Standards CPS 220 on *Risk Management* and CPS 510 on *Governance* do not reference the *Standards* that should be followed by internal auditors.

This is an omission by APRA, as it effectively allows people who practice internal auditing to do so without any adherence to professional standards whatsoever. In contrast, ASIC in their Information Sheet 221 do reference the *Standards*.

The *Standards*, issued by the International Internal Audit Standards Board, is the only set of standards available to those practicing internal auditing in Australia.

5. Legislation

Under the *Corporations Act 2001*, an external auditor cannot be obstructed in carrying out their duties. Under section 311 an [external] auditor when conducting an audit must advise ASIC if there is a breach, and under section 1310 "a person must not obstruct or hinder ASIC or any other person in the performance or exercise of a function or Power under this Act." Yet an internal auditor can be hindered or obstructed in their duties without the same protections.

There is need for consistency in treatment across all regulations, and particularly across the financial services sector, on how internal auditors can be better protected.

External auditors provide assurance around the reliability of a company's financial statements at a point in time over a short period of the year. Internal auditors, on the other hand, investigate all aspects of a company's operations, often over the whole year, and are more likely to detect and report wrongdoing.

The Commonwealth Parliament recently passed the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017*.

This resulted in internal auditors being included under section 1317AAC of the *Treasury Laws Amendment (Enhancing Whistleblower Protections) Bill 2017* as 'eligible recipients', which includes (1) (b) an auditor, or a member of an audit team conducting an audit, of the body corporate or a related body corporate.

The reference to an auditor in the Bill includes external and internal auditors as explained in the Revised Explanatory Memoranda (Page 27).

The Bill expands whistleblower protection and remedies for corporate and financial sectors to include current and former officers, directors, employees, contractors, suppliers and unpaid workers.

The Bill expands the types of disclosures, which will impact on the role of an internal auditor, to include conduct in a regulated entity such as 'misconduct, improper state of affairs or circumstances, contravention of any law administered by ASIC and APRA, conduct that represents a danger to the public or the financial system, or a breach of any Commonwealth law that is punishable by imprisonment for 12 months.'

The level of protection provided for whistleblowers includes strengthening the requirement of confidentiality of whistleblowers identity so they no longer have to identify themselves when making a disclosure, ensuring that regulators and others cannot require disclosure of the identity of a whistleblower, and that whistleblower information is not admissible as evidence against them.

The Bill may provide some protection to internal auditors when receiving information from whistleblowers, but does not address all issues faced by an internal auditor around access to information and protection from obstruction and hindering.

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6. Approaches to External Audit Quality Review

There are a number of approaches that the Inquiry could take. One approach would be to instruct the Accounting Professional and Ethical Standards Board (APESB) to oversee the review of audit quality.

The difficulty is that it is not a truly independent body. It is funded by the three peak Australian accounting bodies, and therefore cannot be considered without a review of its structure, funding and mandate.

The APESB does have jurisdiction over standards, performance and disciplinary matters. A review of audit quality could be included as part of the remit of this body.

APESB currently issues Guidance notes for the application of values and principles which cover Code of Ethics and professional standards for professional accountants.

Also, APESB issues two standards that relate to firm-wide quality control and risk management: APES 320 *Quality Control for Firms*, (which is consistent with ISQC 1 *Quality Control for firms that perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*), and APES 325 *Risk Management for Firms*.

Therefore, our first suggestion is to strengthen the APESB review regime, perhaps with Australian Government support and funding.

Extending this logic, the next obvious candidate to assume a wider role is the Auditing and Assurance Standards Board (AUASB). As the body that has powers to create Standards with legislative force, the Board could also be given the power to provide proper oversight and also ensure their standards are being properly followed.

Obviously, the Board would need the legislative mandate and increased funding to take a greater role in quality reporting oversight. This could involve an active review of audit firms.

A third option is to recommend the creation of an independent Australian Government statutory body to actively review the quality of financial reporting. It could be called the Financial Reporting Quality Commission or similar. While ASIC currently performs this role, ASIC's reviews indicate that a stronger regime may be necessary.

Australian Government commissions similar to the one suggested already exist in a number of areas, for example in the aged care, charities and the disabilities sectors.

Finally, the *International Standards for the Professional Practice of Internal Auditing* require internal assessments and external assessments of internal audit functions to be undertaken periodically to appraise the quality of internal audit. This is an option that could be adapted for external audits.

In an internal audit setting, this culminates in a mandatory, external quality assessment conducted at least once every five years by a qualified, independent assessment team from outside the organization being audited. In this case, the report comments on levels of conformance with the international standards. The report typically goes to the Chair of the Audit Committee for noting. Applying a similar model to external audit would occur in relation to audit firms and how they abide by accounting standards. The external quality assessment report could be referred to a regulator, or similar, who would monitor overall audit quality and measure performance, positive or negative, across the country.

7. Recommendations

1. That AUASB be instructed to incorporate the following amendments in Australian Auditing Standard ASA 610:
 - a. If an entity has an internal audit function, it must follow the International Professional Practices Framework (IPPF), which includes "The International Standard for the professional Practice of Internal Auditing".
 - b. If an entity has an internal audit function, the head of that function should be suitably qualified, or have immediate access to someone who is, and have a direct reporting line to the board or to the board audit committee in order to bring the requisite degree of independence and objectivity to the role*.
 - c. Internal auditors should be members of the Institute of Internal auditors-Australia, the professional association representing the profession.

*Recommended qualifications for an internal auditor – either Certified Internal Auditor® (CIA®) designation or GradCertIA qualification or as Professional Member of the Institute Internal Auditors – Australia (PMIIA).

2. That the Australian Prudential Regulation Authority (APRA) be directed when revising Prudential Standard 510 to incorporate (a) and (b) as above.
3. The Parliamentary Inquiry review the role of APESB and/or AUASB with a view of expanding the roles to include audit reviews.
4. A new independent statutory authority be created to review financial reporting.

About IIA-Australia

The Institute of Internal Auditors – Australia is the professional body representing Australian internal auditors. It has around 3,000 members made up of internal auditors in government, the corporate sector, and professional practice. IIA – Australia is the local affiliate of the global Institute of Internal Auditors (The IIA) which represents more than 200,000 members in 170 countries.

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

The IIA's *International Standards for the Professional Practice of Internal Auditing* (the *Standards*) set the minimum standards for internal auditors worldwide. All IIA members globally are required to comply with the *Standards* under the IIA's by-laws.

All internal auditor members must demonstrate compliance with the *Standards* through an independent quality review of the internal audit function every five years.

The international qualification for internal audit is the Certified Internal Auditor® designation. This certification ensures a base level of competence required to perform and sign off on internal audit work.

IIA-Australia also offers the Graduate Certificate in Internal Auditing (GradCertIA). It is a higher education qualification accredited by the Australian government's Tertiary Education Quality Standards Authority. It also ensures a base level of competence required to perform and sign-off on internal audit work.

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Key definitional differences between external audit and internal audit ¹

External audit and internal audit often use the same terms when communicating with audit committees and the board. However, the meaning of such terms is often fundamentally different within the context of their specific activity. This appendix sets out some commonly used terms that may have different meanings.

Commonly used term	External audit usage	Internal Audit usage
Assurance engagement/ services	An engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. There are levels of assurance provided by assurance engagements/services namely limited or reasonable assurance. Reasonable assurance provides the greatest degree of assurance to users.	An engagement involving objective examination of evidence for the purpose of providing an independent assessment on governance, risk management, and control processes for the organization. Examples may include financial, performance, compliance, system security, and due diligence engagements.
Independence/ Independent	Ensuring an objective mindset, avoiding appearance and/or perception issues and avoiding conflicts of interest occurring. Practitioners are required to comply with this definition. Professional services firms and the members of an external audit engagement must be independent of the client, considering such factors as the scope of services the firm provides to the client, as well as the employment history and personal financial holdings of the engagement team and others in the firm.	The freedom from conditions that threaten the ability of the internal audit activity to carry out internal audit responsibilities in an unbiased manner. This refers to organizational independence or the hierarchical and reporting independence of the internal auditors from those whose work they are reviewing.
Internal audit	The internal audit function means a function of an entity that performs assurance and consulting services designed to evaluate and improve the effectiveness of an entity's governance, risk management and internal control processes.	Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk

¹ *Audit Committees: A Guide to Good Practice, Third Edition (2017)* by Australian Institute of Company Directors (AICD), Auditing and Assurance Standards Board (AUASB) and Institute of Internal Auditors (IIA-Australia) publication pp 95 & 96

Commonly used term	External audit usage	Internal Audit usage
		management, control and governance processes.
Fraud	<p>An intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage.</p> <p>External audit will (a) identify and assess the risks of material misstatement of the financial report due to fraud; (b) obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud; and (c) respond appropriately to fraud or suspected fraud identified during the audit.</p>	<p>Any illegal act characterized by deceit, concealment, or violation of trust. These acts are not dependent upon the threat of violence or physical force. Frauds are perpetrated by parties and organizations to obtain money, property or services; to avoid payment or loss of services; or to secure personal or business advantage.</p> <p>Internal audit is directly concerned with the prevention of fraud in any activity undertaken.</p> <p>Internal Audit has a risk tolerance level lower than external audit, which relates "Risk of Material Misstatement" for the financial audit period in scope.</p>