



OFFICE OF
THE CONTROLLER AND AUDITOR-GENERAL
Te Mana Arotake

**THE RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL
AUDIT IN THE PUBLIC SECTOR**

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INTRODUCTION

In almost every sense the relationship between internal and external audit should not differ between the public and private sectors. This is because essentially the same standards apply and the individuals involved in the audit process share a common base of training and experience.

What's more, auditors (both internal and external) are (or should be) ultimately concerned about the wise and prudent management of entity resources that have been entrusted to managers on behalf of the entity's "owners".

The title of this presentation implies there is a different relationship between internal and external audit in the public sector, in comparison with the private sector. In fact the similarities between the two sectors greatly outweigh any differences – although there are several unique features in the public sector that stem from the Auditor-General's responsibilities under the Public Audit Act 2001. I will elaborate on these unique features later.

**WHAT STANDARDS REGULATE THE RELATIONSHIP BETWEEN INTERNAL
AND EXTERNAL AUDIT IN THE PUBLIC SECTOR?**

Auditing Standards that Apply to Internal Auditors

Members of the Institute of Internal Auditors are required to comply with the *International Standards for the Professional Practice of Internal Auditing*. The requirements that guide the relationship with the external auditor are set out in:

- Performance Standard 2050: Co-ordination; and
- Practice Advisory 2050-1: Co-ordination.

Performance Standard 2050 states:

“The chief audit executive should share information and co-ordinate activities with other internal and external providers of relevant assurance and consulting services to ensure proper coverage and minimise duplication of efforts.”

Auditing Standards that Apply to External Auditors

The relationship with internal audit is specified in the New Zealand Institute of Chartered Accountants (NZICA) Auditing Standard AS-604: *Considering the Work of Internal Audit* and the accompanying Auditor-General’s Statement AG-604¹.

AS-604 will be reviewed and updated as a result of the project initiated by the International Federation of Accountants to review and harmonise auditing standards internationally. We do not believe this process will result in any significant changes to the requirements of AS-604.

Commentary on the Standards

The respective standards emphasise the different perspectives of internal and external auditors about their relationship.

The Institute of Internal Auditors performance standard and practice advisory are very much concerned with audit efficiency through co-ordination of effort and minimising the duplication of effort.

The external auditing standards are very much focussed on the **effectiveness** of external audit (with efficiency being a secondary consideration). Emphasising audit effectiveness can be sourced back to the imperative that the external auditor must be, and be seen to be, independent. From the perspective of the external auditor, internal audit is a component of the control environment of the entity.

The focus on audit effectiveness becomes apparent when we refer to the black letter or mandatory paragraphs of AS-604 which state:

Paragraph 13 The external auditor must obtain a sufficient understanding of internal audit activities to assist in planning the audit and developing an effective audit approach.

Paragraph 15 During the course of planning the audit, the external auditor must perform a preliminary assessment of the internal audit function when it appears that work of internal audit is relevant to the external audit in specific audit areas.

Paragraph 20 If the external auditor intends to rely on specific work of internal audit, the external auditor must evaluate and test that work to confirm its adequacy for the external auditor’s purposes.

¹ AG-604 is one of the Auditor-General’s Statements that make up the Auditor-General’s Auditing Standards which can be accessed on www.oag.govt.nz.

The respective standards correctly recognise the different roles of internal and external auditors and the relationship that should exist between them. Unfortunately it is the very standards that can lead to the frustrations sometimes experienced by internal auditors when they feel their work is not given sufficient credit by the external auditor. These frustrations are often amplified when Chief Executives start questioning the “total audit spend”, or note that the external auditor of another public entity seems to be placing greater reliance on that entity’s internal audit function.

These are issues that can sometimes be difficult to explain – particularly when the budget is under pressure. I will return to these issues later.

WHAT ARE THE EXTERNAL AUDIT ARRANGEMENTS IN THE PUBLIC SECTOR?

The Public Audit Act 2001²

The Auditor-General’s mandate is specified in the Public Audit Act 2001 (the Act). The key features of the Act are:

- The Auditor-General is an Officer of Parliament (section 7).
- The Auditor-General must act independently (section 9).
- The Auditor-General is the auditor of every public entity (section 14). ‘Public entity’ is defined in section 5.
- The Auditor-General appoints auditors to act on his behalf (sections 32 and 33).
- The Auditor-General must conduct a financial report audit (section 15) and may at any time (under section 16 – the performance audit) examine matters of:
 - Effectiveness and efficiency;
 - Compliance with statutory obligations;
 - Waste;
 - Lack of probity or financial prudence.

The annual audit consists of the financial report audit and aspects of the performance audit.

- The Auditor-General is required to publish the auditing standards that are applied, or are intended to be applied, to the conduct of audits, and table them in Parliament every three years (section 23).

² A copy of the Public Audit Act can be viewed on www.oag.govt.nz.

The Allocation of Audits to Appointed Auditors

Understanding how external auditors are appointed in the public sector may assist in developing and enhancing effective working relationships between internal and external auditors in the public sector.

There are around 4,000 public entities, each of which needs to be audited annually. The Auditor-General does not have the capacity within his own organisation (consisting of the Office of the Controller and Auditor-General (OAG) and Audit New Zealand) to conduct all audits of public entities.

The Auditor-General therefore appoints auditors from private sector firms, under his powers of delegation, to conduct audits on his behalf. The Auditor-General uses around 130 appointed auditors from about 70 private sector firms for this purpose.

The Contestable Audit Process

Successive Auditors-General progressively introduced a contestable process for appointing auditors of many public entities from 1990 to 2000. This process involved tenderers needing to meet certain audit quality and independence pre-requisites before they could be considered for shortlisting. A tender process was run, primarily based on attributes of audit quality with a quality/cost decision at the end of the process. While most public entities were offered the opportunity to participate in the audit tender process, only about 10% of public entities actually participated in tender processes.

The contestable process served its purpose by bringing a significant level of new capacity (and an emerging capability) into public sector auditing. The process also demonstrated the efficiency of Audit New Zealand – which was previously seen as a monopoly audit service provider. But it had its downsides.

Our main concerns about continuing with a contestable audit approach were:

- The failure of firms to win enough tenders to gain the efficiencies of sector specialisation;
- The potential for tendering to affect independence (ie. Auditors seeing public entities as their clients rather than the Auditor-General);
- High tendering costs;
- Withdrawal of private sector audit services from some locations and some sectors; and
- Reduction in the range of appointment options following mergers of firms.

Audit Allocation

After a review of the contestable audit process in 2001/02, the Auditor-General moved to a system of audit allocation - although some audits of commercially oriented public entities continue to be subject to the contestable process. What this means is the firms who undertake to develop and maintain long-term audit capacity and capability in a sector (such as the health or local government sector) are allocated an amount of audit work in that sector sufficient to justify their investment in sector capability – although the particular audits they conduct in that sector may change.

WHAT ARE THE DIFFERENCES IN THE PUBLIC SECTOR THAT IMPACT ON THE RELATIONSHIP BETWEEN INTERNAL AND EXTERNAL AUDIT?

As mentioned above, the relationship between internal and external audit is largely the same in the public sector as it is in the private sector. There are, however, several unique features of the Act that may impact on the internal-external audit relationship.

Duty to Act Independently

Section 9 of the Act imposes a duty on the Auditor-General to act independently in the exercise and performance of the Auditor-General's functions, duties and powers. Although section 9 doesn't specify what the Auditor-General must act independently of, there is a clear expectation that Parliament expects the highest standards of independence from the Auditor-General, his employees and his appointed auditors and their firms.

The tangible expression of the Auditor-General's independence is in the Auditor-General's Statement on Independence³ which imposes higher standards of independence on those who conduct audits on his behalf than the independence standards of the NZICA that apply to auditors generally.

Section 9 may also lead external auditors in the public sector to take a more conservative approach when making assessments about whether to rely on the work of internal audit. For instance, if the decision to rely on internal audit is a margin call, the external auditor may decide to not rely – with the duty of acting independently being the determining factor.

The Wider Audit Scope

Under section 16, the Auditor-General has an interest in matters of:

- Effectiveness and efficiency;
- Compliance with statutory obligations;
- Waste; and
- Lack of probity or financial prudence.

The wider scope of the public sector audit, as specified in section 16, may mean that external auditors want to understand and review aspects of internal audit activity beyond the traditional areas of internal control and dollars. Furthermore, if any matters identified by internal audit meet certain thresholds of significance, the external auditor is duty bound to report these matters to the OAG. This might, in turn, lead the OAG to initiate further work in the form of a performance audit or an inquiry which may act as a disincentive for the internal auditor to fully disclose all relevant matters to the external auditor.

³ AG-Code of Ethics: Independence in Assurance Engagements can be accessed from the Auditor-General's Auditing Standards on www.oag.govt.nz.

Wide Reporting Powers

Section 21 gives the Auditor-General the power to report to any entity or person on any matter arising from the work of the Auditor-General. The power to report under section 21 is subject to the “balancing of interests” disclosure provisions of section 30. Under section 30 the Auditor-General must consider three matters before disclosing any information – as follows:

- The public interest;
- The auditor’s professional obligations concerning confidentiality; and
- The Official Information Act 1982.

The significance of sections 21 and 30 is that any matter arising from internal audit activity that is either brought to the attention of, or noted by, the external auditor is potentially publicly reportable under section 21.

The Auditor-General recognises that section 21 is a powerful tool at his disposal. Any decision to report publicly under section 21 is subject to very careful processes that take full account of the balancing of interests criteria specified in section 30.

Unwelcome publicity is a risk to any organisation – and is a risk that internal auditors acknowledge and actively work to avoid. Internal auditors manage this risk primarily by making sure that the conditions that might lead to unwelcome publicity (such as deficient internal control systems, or the failure to properly manage conflicts of interest) don’t arise in the first place.

As auditors, we should be guided by the axiom “*sunlight is the best antiseptic*”. From the perspective of the public sector external auditor we would not want internal auditors to inhibit or suppress their reporting practices simply because the Auditor-General might get hold of it. Indeed, we would encourage internal auditors to take the initiative and inform the external auditor when a serious matter comes to their attention. The external auditor always appreciates being informed of such matters sooner rather than later – and can often be used as a sounding board when issues arise.

SOME TOPICAL ISSUES

Consistency of Approach by the Auditor-General’s Appointed Auditors

Internal auditors are sometimes frustrated when the external auditor decides to either not to rely on their work, or only partially rely on their work.

A more worrisome situation can develop when the internal audit operation is threatened because entity management expect the external auditor to use the work of the internal auditor – and start asking questions about internal audit competence when that doesn’t happen.

Warding off this situation is not helped when entity management become aware that external auditors of other entities are placing reliance on the work of internal audit.

From the Auditor-General's perspective, consistency of approach and audit efficiency is desirable, but it is not a driving principle in the decision on whether to rely on the work of internal audit. Auditing is a function of professional judgement by appointed auditors and their teams, which is based on the requirements of auditing standards.

No two circumstances are identical, and comparison of the approach taken by different external auditors of different entities can lead the uninformed to reach incorrect conclusions.

External auditors, however, do have a responsibility to inform internal audit and entity management of their reasons for deciding not to rely (or only partially rely) on the work of internal audit. This is a reasonable expectation, although we would not expect the entity to challenge the external auditor's decision unless there were significant factors that the external auditor had not taken into account. Conceivably, external auditors could also be asked to justify why they have decided to rely on the work of internal audit – although there seems less concern from an entity perspective for such a justification.

The Auditor-General's expectations of appointed auditors, in respect of their relationship with internal audit, are that appointed auditors will:

- Follow the requirements of AS-604 and the accompanying Auditor-General's Statement AG-604. In particular, we would expect appointed auditors to keep themselves informed of internal audit reports and findings in a timely manner - even although they may have decided not to rely on the work of internal audit; and
- Inform internal audit and entity management about their decision on whether to place reliance on the work of internal audit.

Formal Protocols between Internal and External Auditors

In recent times we have seen the development of formal protocols between internal and external auditors. Protocols can be useful if they contribute to improved audit transparency and an understanding of the respective roles of internal and external auditors.

Some protocols we have seen are unacceptable in that they are worded in the form of a contract or agreement that gives the appearance that the external auditor is not independent of the entity.

For instance, we have seen protocols that ask the external auditor to agree to give the internal auditor reasonable access to working paper files. We would regard such an agreement as inconsistent with the general requirement for the external auditor to be independent. Furthermore, such an agreement may also be stretching the intent of paragraph 17 of the NZICA Auditing Standard AS-204 on documentation. Whilst the external auditor might consider specific requests from the entity to make portions of, or extracts from the working papers available, such requests will only be considered on a case-by-case basis at the discretion of the Auditor-General and the appointed auditor.

“Hold Harmless” Letters

On occasions the external auditor is asked to sign a “hold harmless” letter before being given access to the internal audit files. This is often the case when the entity outsources its internal audit activity to a chartered accounting firm.

External auditors have no difficulty signing a hold harmless letter because the responsibility to render an opinion on the financial statements rests solely with the external auditor. That responsibility is not divisible and cannot be reduced by internal auditor involvement – irrespective of the existence of a hold harmless letter.

However, a particular difficulty arises in the public sector when the external auditor is asked to sign a hold harmless letter that asks the external auditor to indemnify the internal auditor and its personnel from any claim arising as a result of permitting access to internal audit files. The difficulty arises because the Auditor-General (the auditor by law) is not permitted to give a guarantee or indemnity under the Public Audit Act (clause 7 of Schedule 3).

If the internal auditor is insistent on receiving a hold harmless letter we have usually managed to agree to rephrase the letter along the following lines. “We understand and acknowledge that the sole responsibility for expressing the audit opinion on the financial statements rests with the Auditor-General and our firm, as his agent, and that this responsibility is not and cannot be reduced by any use made of the work performed by the internal auditor. As a consequence, any risks associated with our use of the work performed by the internal auditor rest with the Auditor-General and our firm.”

Local and International Developments

Publicity about the role of external auditors in high profile cases (Enron, HIH Insurance, Ross Armstrong’s TVNZ role, etc) have increased public and Parliamentary expectations of external auditors, and rightly or wrongly have made external auditors more cautious about the degree of reliance they place on internal audit.

CONCLUDING COMMENTS

How might we describe the relationship that should exist between internal and external audit?

The auditing standards correctly define the respective responsibilities of internal and external auditors. From an external auditor’s perspective the relationship is shaped by the overriding requirement to be, and to be seen to be, independent. The next consideration is to plan and conduct an effective audit. Co-ordination of audit effort may be an outcome that emerges once the external auditor is satisfied that the imperatives of independence and audit effectiveness have been met.

Despite the shaping influence of the auditing standards, which can lead to tensions in our relationship, it is important to recognise that we are both ultimately concerned about the wise and prudent management of entity resources. If we are to achieve this objective we must ensure we keep each other informed of matters of mutual interest – irrespective of how we

approach our day-to-day tasks and irrespective of the level of reliance placed on the work of internal audit by the external auditor.

It is the mutual respect that we hold for one another that shapes and gives strength to the relationship between internal and external auditors. The relationship is nourished through regular and open communication of matters of mutual interest.