
Fixing Internal Audit: One More Try

Alan Gilmore

On April 1, 2006 the Treasury Board Secretariat's (TBS) new Internal Audit Policy came into effect. As the 40 year history of well-intentioned, but failed attempts to establish an effective internal audit sector in the federal government indicates successfully implementing the policy will be difficult. In this light, perhaps, a less inauspicious date for the policy to come "into effect" could have been chosen. The obvious questions are why have past efforts failed so conspicuously and do the new policy and internal audit provisions of the proposed *Federal Accountability Act* have a better chance of succeeding.

To tackle these questions we need to go back at least to the 1962 Report of the Royal Commission on Government Organization (better known as the Glassco Commission.) There was little departmental internal auditing prior to the Glassco Report. Most auditing was done from the centre by the Comptroller of the Treasury. Managers believed that the Comptroller patrolled departments to ensure "financial rectitude." Glassco, however, was not a fan of central control. In fact, he recommended the creation of departmental audit groups as a corollary to his famous slogan "let the managers, manage." In response to Glassco the TBS, in 1966, introduced a plan which was supposed to lead to the establishment of internal audit functions in departments. In 1969 the Comptroller of the Treasury was disbanded leaving central agencies with little information on how well their policies were being implemented.

The state of the internal audit sector was not reviewed again until 1975. The Auditor General's 1975 Financial Management and Control Study found that some departments had no internal audit function, some had diverted auditors to other projects and auditors were not well trained or knowledgeable about their responsibilities. Three years later the 1978 Auditor General report

found that internal audit across government was in disarray. Although departments were spending about \$50 million on auditing, there was little to show for it. Specifically,

- several groups in a department were involved in uncoordinated audit activities
- the responsibilities of most audit groups were not defined
- few departments paid more than lip service to determining priorities based on materiality and risk — there was a tendency to choose the easiest matters to audit
- the low organizational importance placed on internal audit meant they were neither independent nor objective
- there was no assurance audits had been properly carried out
- audit reports were issued long after completion of audits reducing the value of the process and reports never reached managers who could take corrective action
- some departments had not appointed audit committees and where committees had been appointed they were not meeting their responsibilities
- the prevailing attitude toward audit was one of resentment resulting in the departure of better auditors
- central agency support for internal audit had been "spasmodic and often divisive"

Sixteen years after the Glassco Commission, in 1978, the newly created Office of the Comptroller General (OCG) launched an initiative to improve internal audit. For example, in 1980 it established an Internal Audit and Special Studies Division to assist departments. In 1982 it issued standards for internal audit. By 1984 the Auditor General was able to report that the "government [had] made significant progress" overcoming most of the deficiencies in organizational structure identified in 1978 with the major exception of audit commit-



Alan Gilmore

Alan Gilmore, Ph.D. is a former senior principal in the Office of the Auditor General of Canada. He has extensive experience reviewing values and ethics initiatives, and governance and regulatory frameworks. He was responsible for the Auditor General's recent reports to Parliament on the Costs of Implementing the Canadian Firearms Program and Accountability and Ethics in Government. He is professor in Public Affairs Ethics in the Faculty of Philosophy at Saint Paul University, Ottawa, and he is an Associate with the strategic policy and management consulting firm Sussex Circle.

tees. "Some committee meetings were little more than a formality" and some committee members "did not appear to clearly understand their roles and responsibilities."

Fifteen years later, in 1993, the Auditor General reported that internal audit had failed to live up to its expectations. A scaled back OCG had reduced its leadership role. Performance of internal audit groups varied greatly. "Very little work" was carried out to identify risks and in some departments only areas suggested by managers were reviewed. In addition, internal audit was being "too often used [by departments] as a place to relocate people without potential for advancement in other areas."

In addition, management attitudes toward internal audit had not changed. Despite more than 30 years of preaching the value of internal audit, senior managers still told the Auditor General that "they would not have an internal audit group in their organizations if the Treasury Board did not require them to do so." Frustrated with this lack of appreciation for internal audit, the Auditor General lectured that deputy heads and senior managers "must understand the potential benefits of effective internal auditing." If they do not, he said, "there is little prospect [that they] will be able to realize the benefits of internal audit that their colleagues outside the federal government enjoy."

The 1996 Report of the Auditor General documented the effects of restructuring and downsizing on internal audit. Compared to 1993, expenditures on internal audit had dropped to \$48 million from \$56.6 million and the number of internal auditors had decreased to 590 from 700. In addition, the Auditor General concluded that the newly introduced TBS Review Policy was not helping because its various statements on the role of internal audit had “at the most fundamental level... introduced confusion as to what internal audit should be doing.”

By 2000, the TBS Study of Internal Audit in the Federal Government estimated that as a result of downsizing “there are no more than 300 internal auditors, and that total expenditures for internal audit in the federal government [was about] \$30 million.” Thus, over a seven year period, the expenditures on internal audit had decreased by \$26.6 million and the number of auditors had declined by 400. These are ballpark estimates. It’s likely that the expenditures and the number of auditors in departments were much lower than the figures suggest since the numbers include the large internal audit function that Revenue Canada continued to maintain.

In 2001 the TBS estimated that there were only 240 auditors. It issued a revised policy on internal audit and allocated new funds so that by 2002-03 expenditures had risen to \$54 million – nominally about the same as was being spent in 1975 but much less after taking inflation into account. The 2003 TBS evaluation of the policy’s implementation reported that the internal audit sector was under-resourced by 162 full time equivalent staff and \$18.3 million.

After reporting on the problems in Human Resources Development Canada’s grants and contribution program (2000), the Canadian Firearms Program (2002) and the Sponsorship Program (2003), the Auditor General issued a sixth report on internal audit (2004). This report assessed the extent to which internal audit in six departments and agencies met international standards for the professional practice of internal auditing. The Auditor General found that internal audit was in much the same state as it was two decades earlier. For example,

- two departments generally met the professional standards, while three partially

met them and one did not meet many of the standards

- while the primary role of internal audit was to provide assurance that management control systems were effective, limited assurance work was being done
- the quality of internal audit varied widely and audit reports were not timely
- three of six deputy ministers did not strongly support their audit functions
- departmental audit committees lacked independence and audit committee members did not fully understand their responsibilities
- there was insufficient funding for internal audit and departments had difficulty attracting and retaining qualified staff
- there was no capacity to provide audit services to small agencies

Is there any hope that the new 2006 TBS Internal Audit Policy will fare better than its predecessors? Some of the features of the policy give it a better chance of working, particularly the key innovation of creating an Independent Audit Committee to actively oversee departmental governance systems. According to the policy, the objective of internal audit is to provide “deputy heads and the Comptroller General, respectively, with *added assurance, independent of line management*, on risk management, control and governance processes [emphasis added].” The cornerstone of the new policy is the creation of an “Independent Audit Committee” (IAC) to play an “active oversight” role and provide the “added assurance” on a department’s risk management, management control framework and governance processes, including accountability reporting and arrangements to foster sound public service values and ethics.

In contrast to the 2001 policy which called for audit committees chaired by the deputy or associate deputy minister with a membership of assistant deputy ministers, the 2006 policy requires that a majority of the three to five member IAC, and preferably its Chair, be from outside the government. While the IAC provides its advice to deputy head in the first instance, the policy also provides for IAC reports to be forwarded to the Comptroller General and for the IAC to meet with the responsible minister.

The IAC is required to report annually to the deputy head the results of its review of:

- internal and external audit reports
- management representations on risk management, management control frameworks, and governance processes
- accountability reports, e.g., departmental performance reports
- financial statements
- management action plans to address audit recommendations and implementation progress
- the performance of internal and external auditors

The IAC has the authority to obtain advice and services from outside a department. But in most instances it will likely rely, like its counterparts in Crown corporations and the private sector, on internal audit to provide the information to develop its assurances. A small Secretariat, probably located in the internal audit function, will be needed to support the IAC by coordinating meetings and agenda, obtaining information, providing reports, and writing draft IAC reports. Implicit in the policy is the expectation that responsible managers will provide the IAC with reports (management representations) on the state of departmental and program risk management procedures, management control framework and governance processes and meet with the IAC to discuss these reports.

Predictably, these innovations have raised concerns. There are concerns about the cost. Clearly, accountability cannot be bought cheaply. The government will have to provide sufficient funding or the policy will fail. There are suggestions that people with the required expertise will not be willing to take on IAC member responsibilities for four years with, perhaps, an annual workload of 20 or more days at current government per diems. This may not be a major issue since the government does not seem to have any problem staffing its many boards and commissions at current per diems. There are also concerns that the IAC may not be sufficiently independent because the policy allows deputy ministers to be Chairs or members of the Committee and other senior managers to be members. Such an arrangement appears to conflict with the IAC’s purpose to provide added independent assurance to the deputy minister. It would be wise to revise the policy to avoid this perceived or real conflict of interest which could compromise the credibility of the IAC.

The resistance of senior management could be a major obstacle. Some senior managers may view the establishment of the IAC as a threat to the deputy minister's and their authority and to the deputy's and their relationship with the minister. They may fear the IAC will take over direction of key areas of departmental governance or, at the very least, overwhelm the department with requests for information and action on recommendations from internal audit, the Comptroller General and the Auditor General. This is unlikely. While the IAC is innovative its role is much less intrusive than audit committees in Crown corporations or the private sector. For example, the TBS guidelines for Crown corporation audit committees state that the committee "on behalf of the board of directors, holds management *accountable* for the corporation's standards of behavior, its financial reporting, and its business systems and practices [emphasis added]." In contrast, the IAC does not hold anyone accountable but rather provides added assurances to the deputy minister that departmental governance systems are working.

Passage of the proposed *Federal Accountability Act* will help bring internal audit out of the cold. The Act reinforces the policy by making the deputy head of a department responsible for establishing an internal audit capacity and an audit committee (albeit not an independent audit committee.) It also makes the deputy head an "accounting officer" accountable to the appropriate parliamentary committee for: using departmental resources to deliver programs in compliance with government policies; taking measures to maintain effective internal control systems; and signing departmental financial statements. In addition, the Act obligates the deputy head to appear before the appropriate parliamentary committee to answer questions on how

these responsibilities were carried out.

In this regard, the IACs could be the deputy minister's best friend. Establishing an effective internal audit function and a credible independent audit committee would allow an "accounting officer" to demonstrate to parliamentary committees that assigned responsibilities are being prudently carried out and that the information being provided in accountability reports is accurate and comprehensive. In practice, deputy heads could rely on the IAC to do the leg work to ensure that departmental management processes are operating well, and, protect the ministers, themselves and the department from unnecessary criticism.

Ministers and senior central agency managers responsible for the legislation and policy can try to persuade their colleagues in departments that the policy will be beneficial. However, given the history of internal audit initiatives this could be difficult to sell. What's necessary is a major change in the reward system and government and media culture.

The appraisal, reward and promotion system of senior managers will need to explicitly include such factors as:

- their degree of co-operation with internal audit and the IAC
- whether they seek internal audits to ensure that programs are operating well
- whether they insist on "tell it like it is" audit reports
- whether audit reports indicate that departmental and program risk management, management control frameworks and governance systems are operating well
- the speed with which they act on audit recommendations
- the accuracy of their management representations on their stewardship of their programs to the IAC and to Parliament in accountability documents such as the

departmental performance report

While changing the reward system is necessary, it is not sufficient. Major cultural changes will be needed for the legislation and policy to work. Departmental internal audit reports are generally made public. If the new approach to internal audit is going to work, the "gotcha" culture of Ottawa will need to change. Establishing an effective internal audit function and an IAC, producing quality audits and fixing the problem have to become as newsworthy as the problems audits identify.

Of equal, if not more importance, will be the need for parliamentary committees to recognize that taking a partisan approach to "accounting officers" may not only politicize deputy ministers but also undermine the new internal audit policy. Establishing an effective and credible IAC could help provide the objective assurances to parliamentary committees needed to sustain the non-partisan role of the "accounting officer" and internal audit.

Suggesting that the media take a more balanced approach to audit reports or that parliamentary committees act in a more non-partisan manner may be unrealistic. However, these realities have to be recognized as key factors affecting the success of the policy.

A lot of pieces will have to fall into place if the new policy is going to work: the TBS will have to provide sufficient funding; credible IACs will have to be established; senior managers will have to be supportive; the quality of audit reports will have to be high, and hopefully, the media will give more balanced reports of internal audit findings and parliamentary committees will deal with "accounting officers" in a non-partisan manner. Clearly, implementing and sustaining this policy will not be easy. ■