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Supplemental Guidance: Optimizing Public Sector Audit Activities

July 2012
Executive Summary

Governments across the globe are considering — or are in the process of — restructuring their internal audit activities. There are several reasons; these include, among others, political, fiscal, or organizational considerations. Generally, economy and efficiency are key benefits identified for centralization, and effectiveness is the key benefit identified for decentralization. The bottom line for each organization is to look at its unique situation and decide what is best.

This guidance describes the advantages and disadvantages of restructuring. It is based on two case studies, described within this guidance.

When considering restructuring public sector audit functions, some general observations can be made:

- Reporting lines of the Chief Audit Executive (CAE) should be very clear. This is particularly important to preserve boundaries and ensure confidentiality. There is the potential that the CAE could have conflicting pressures regarding reporting organizational risks.
- Care should be taken that the audit organization does not become, or is not perceived to be, an “external auditor.” It is essential that it retain the role of “internal audit.”
- Having multiple audit steering committees brings its own challenges; the resolution depends on the particular model used.

Introduction

This guidance examines the potential advantages and disadvantages of restructuring public sector audit activities. The analysis applies to government agencies that have their own internal audit units that are decentralized and are considering their amalgamation, as well as those that have a centralized internal audit organization and are considering partial or complete decentralization.

This guidance does not consider the relative benefits of outsourcing the internal audit responsibilities, even though some of the arguments are used in discussions to support either outsourcing or “in-sourcing” depending on one’s focus.
This guidance presents two scenarios:

- A case where separate organizations, departments, or agencies are being combined under one portfolio and, as a result, the audit activities servicing the separate organizations are being consolidated into one centralized unit.

- A case where an organization had one centralized audit group and has, based on evaluated need, split the activity into separate units to foster better accountability and transparency.

Any organization considering a change from its current organizational structure with respect to management of the internal audit activity should consider the advantages and disadvantages of each option and determine what is best suited for the organization’s current stage of maturity.

As a general rule, any organization that does not have robust administrative processes and sound controls in place among its separate audit units may best be managed centrally. Alternatively, an organization that is mature in its management and is seeking efficiencies, standardization, and consistency across its portfolio may also benefit from centralization.1

Conversely, an organization that services different unique customer needs, is focused on specific audits, and is confident of its overall administration and management of audit resources may best be managed in a decentralized manner.

This guidance assumes that the units being consolidated are closely located geographically and that travel, that affects time and budget, and communication costs are not factors being considered.

This guidance includes two case studies.

- The first, demonstrating the advantages of consolidation, examines the recent integration of the audit responsibilities under one general manager for the Commonwealth of Australia’s Human Services portfolio.

- The second shows the benefits of partially decentralizing the internal audit and advisory services of the City of Austin, Texas (United States). Its goal was to create a control ownership environment with the city’s operational management leading to better accountability and transparency in Austin’s local government.

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1 To determine the maturity level, see the book titled Internal Audit Capability Model (IA-CM) for the Public Sector, copyright 2009, The Institute of Internal Auditors Research Foundation (IIARF).
Advantages of Centralizing the Internal Audit Function

Reasons for centralizing the internal audit activity are not dissimilar to the general arguments for consolidating or bringing together like organizational units. Similar arguments can be presented for integrating (or not integrating) the finance or human resource activities.

Supporting arguments include:

- Streamlining corporate activities for greater cost efficiency.
  - Administrative overhead generally can be reduced by consolidating activities. One example is the savings that can be achieved by bringing together the administrative units (e.g. secretariats) that service the individual boards.\(^2\)

- Integrating responses to central audit authorities.
  - It is important that coordinated and consistent messages are given to supreme audit institutions, such as the Australian National Audit Office. This would be much more difficult to achieve for agencies that have merged without a fully integrated audit activity.

- Providing consistency of service to the chief executive(s).
  - Without a central audit activity, it is possible that a different approach would be adopted by the separate units, resulting in different advice being given to the chief executives.

- Recruiting and training across the portfolio for increased staffing consistency.
  - With its large number of staff, a centralized audit organization can provide more training and standardized recruitment practices, drawing on volumes and economies of scale.

- Sharing and leveraging staff experiences across the portfolio.
  - Under a centralized arrangement, audit staff can be rotated throughout the organization, applying their skills and experience where needed most. Conversely, job rotations can increase exposure and experience in different areas and types of audits.
  - While not always practical in smaller organizations, larger units can develop subject matter experts. These staff should undertake a wider range of audits.

\(^2\) The term “board” is used in this guidance as defined in the *International Standards for the Professional Practice of Internal Auditing (Standards) Glossary*: A board is an organization’s governing body, such as a board of directors, supervisory board, head of an agency or legislative body, board of governors or trustees of a nonprofit organization, or any other designated body of the organization, including the audit committee to whom the chief audit executive may functionally report.
which could prove challenging in job scheduling. Larger units also can develop specialty audit programs.

- Facilitating reporting of portfolio audit activities.
  - Consistent reporting is achieved through having a centralized audit organization.

Conclusion:

- Centralizing internal audit enhances independence from agency management.
- Centralizing the board provides uniform direction and resource coordination, as well as increased visibility and transparency.
- Governments that currently lack internal audit coverage could gain added oversight as a result of consolidation.
- Having only one audit plan better allocates audit resources to enterprise wide goals and minimizes audit duplication and overlap through coordinated coverage of risk areas by internal audit, external audit, and other oversight groups.
- Audit processes become more consistent and streamlined through a centralized model, consistent risk assessment framework, and issue ratings.
- A larger pool of central resources provides pockets of expertise that better align with government risk profiles (e.g., IT audit resources).
- More effective end-to-end process reviews span multiple governmental units.
- Saving costs of internal audit software tools and training can be realized in volume purchases.
- Centralizing quality assurance of the whole internal audit function is a key component driving process consistency and efficiency.

Disadvantages of Centralizing the Internal Audit Function

There are real and perceived disadvantages to integrating like activities, and they can apply generally to any organizational units being combined. For example:

- **Loss of ownership or power.** It can be perceived that integration results in “winners” and “losers.” This is especially the case when a larger unit is perceived as “taking over” a smaller unit.
  - This is an important perception and should be managed by constantly communicating intentions, consulting with staff, and ensuring that appointments in the amalgamated structure are made equitably and without real or apparent favor. If properly managed, “loss of ownership or power” should not be a real threat to integration.
- **Loss of authority.** Ownership by staff means they can be tasked to respond to priorities. When staff is integrated, a different leadership has control of this resource. It is important that the audits carried out by the centralized organization reflect — largely and certainly during the early period of integration — those from the original units.

- **General resistance to change.** Staff members are generally comfortable with the status quo, and resist changes that may impact their comfort level. Change can be seen as a threat to jobs and security, as well as present challenges that staff may not be able to meet.

- **Loss of agility.** A smaller organization can respond more quickly and be more focused in addressing any organizational issue. A small audit activity within an organization can quickly adjust its program to accommodate new priorities, and be more flexible in responding to executive requirements. This agility is diluted in larger organizations. There is also the potential for a decrease of local coverage in larger organizations.

- **Increased bureaucracy.** This, in part, is the mirror image of the loss in agility. Greater numbers of staff often result in increased administrative bureaucracy, as well as smaller overall budgets. As the total costs of the audit activity across the portfolio become evident, they can be a target for budget cuts.

- **Higher workload levels.** Integration inevitably results in a larger workload for audit executives and senior managers. Generally, the increased workload is not compensated by a commensurate increase in resources. As a general rule, the workload increases in proportion to the number of audit activities being integrated. Centralized audit executives respond to the requirements of their executive managers. The workload increase can be particularly heavy in attending meetings and in increased reporting requirements.

- Individual agencies or government entities can lose control over internal audit coverage for new, emerging needs.

- If not placed correctly within the organization, internal audit’s role and importance may diminish.

- Centralization often reduces the number of senior internal audit managers and can create a loss of expertise that executive management still requires.

- Reduced ongoing presence in local units of government may limit internal audit’s advisory role. Upfront assurance and consulting is an ideal position for internal audit.

- Media risk to agencies or governments is not always confined to larger organizations and processes. Increased communication is required to foster better awareness and understanding due to less daily interaction.

- Central accumulation of internal audit costs may increase budget accountability and scrutiny.
General Observations

Some general observations can be made when considering consolidating public sector audit activities, including:

- The reporting line(s) of the CAE should be very clear (i.e., who is actually in charge). This is particularly important to preserve boundaries and ensure confidentiality. There is the potential that the CAE could have conflicting loyalties in reporting organizational risks.
  - The authority of the CAE to escalate issues to the chief management executive(s) should be clearly defined.

- Care should be taken that the consolidated audit organization does not become, or is not perceived to be, an “external auditor” rather than retaining the role of internal audit.
  - For this reason, it is important to retain staff in the same physical locations as before the consolidation.
  - It is also important that the chief of the consolidated internal audit activity regularly attends executive forums of the integrated agencies.

- Having multiple audit steering committees brings its own challenges, and resolution depends upon the particular model used. Consideration can be given to:
  - Each retaining its existing role and responsibilities.
  - Establishing a supreme board with overarching authority.
  - Having a degree of common or shared membership.
The Australian Case Study – Centralization

In the case of the Commonwealth of Australia’s Human Services portfolio, five separate public sector organizations have been brought together and their audit functions integrated as a part of the government’s Service Delivery Reform agenda, known locally as “works for you.”

Each of the five agencies provides some aspect of human services.

- **The Department of Human Services** aims to improve government, social, and health-related services to all Australians.
- **Centrelink** delivers a range of Commonwealth services to the Australian community to assist people in becoming self-sufficient and supports those in need.
- **Medicare Australia** assists in improving health outcomes in Australia.
- **Commonwealth Rehabilitation Service** is a leading provider of disability management and assessment services to people with a disability, injury, or health conditions.
- **Child Support Agency** supports separated parents to transfer payments for the benefit of their children.

Planning

The planning for the amalgamation separated the implementation into three separate phases:

**Phase 1: Amalgamation.** This phase took effect quickly and changed the reporting lines of audit staff in the five agencies by requiring that all audit staff report to the chief audit executive, who is referred to as the “Portfolio General Manager, Audit.”

**Phase 2: Consolidation.** This phase comprised a six-month program commencing from the date that the reporting lines were changed. It considered and proposed new roles for the separate audit committees and made other short-term administrative changes, including:

- Integrating the separate audit manuals.
- Standardizing the different audit protocols.
- Uniting filing and records management.
- Rationalizing staff training.
- Organizing computer access across the amalgamated units.
- Arranging access passes to buildings.
Phase 3: Integration. This phase included an 18-month period awaiting the passing of legislation by the federal parliament to make a fully integrated audit organization legally possible.

Details of these phases were submitted by the general manager and subsequently were approved by the chief executives of all the agencies being amalgamated.

Principles Applied to the Consolidation

A set of principles was applied when developing the amalgamated structure.

- The integrated structure would retain senior positions that would, as a prime responsibility, manage the audit activities for each of their former agencies. Agency heads could call on these positions for advice and to conduct work on behalf of their agencies.
  - This eliminated any perception that the bigger audit organization was no longer responsive to individual agency executives or that their requirements would not be given appropriate attention or priority.
- There would be only one audit executive responsible for delivering the overall portfolio audit program.
  - While, as a matter of practicality, the individual audit programs were retained and implemented — generally by the same management and staff prior to the amalgamation — the audit executive had overall responsibility for the program’s delivery and was accountable to the individual agency’s chief executive.
- Administrative functions would be fully integrated.
  - This would not only achieve savings through rationalization and increased effectiveness, but also was an important integrating activity so that the previous administrative activities could be blended into one.
- Staff continued to carry out their audits prior to consolidation, and would continue to be located in their existing premises.
  - This allowed staff to maintain their contacts within their former agencies and minimized disruption while the separate phases were being implemented.
  - A process was then launched to relocate staff as necessary, after consultation, with the more senior positions being the first to be relocated.

Experience to Date

The experience has been mostly beneficial and positive from every perspective. There have been some lessons learned from the Australian experience, including:

- Workload increased rapidly for everyone involved — especially the senior audit managers.
Senior audit managers’ workload increased as a result of the need to attend meetings in the former agencies to update their executives on audit matters. Reporting requirements increased in proportion to the number of agencies being consolidated.

- Necessity to engage management executives.
  - It is necessary to engage the top executives of the agencies that have been amalgamated. This diminishes concerns and assists in building confidence in the amalgamated organization.

- It is important that staff be consulted about all the changes and management communicate proposed changes.
  - In the absence of frequent communication and consultation, rumors are likely to circulate. Staff are mostly concerned with:
    - Whether their salary will change.
    - Their physical location.
    - Whether career prospects will be enhanced.

- It is best for the consolidation (as well as decentralization) to be implemented in defined stages.
  - “Big bangs” should be avoided. A phased implementation causes the least disruption. For example, the audit programs are maintained, clear and detailed instructions can be developed and promulgated, and staff — as well as the portfolio — become familiar and at ease with the changes.

- It is necessary to clarify leadership and financial delegations up front, given the changed reporting lines and authority for spending funds.
  - The executives of the organizations being consolidated will invariably have different levels and types of delegations — both for staffing and budget matters. It is important that the delegations and authority of the executives of the consolidated audit unit be determined as soon as possible.

- Consider and define the roles of audit steering committees.
  - This is an important aspect given, in some countries, the legislative requirement of these committees and the responsibility of the agency heads for their respective audit programs.

- Assurance and risk mitigation.
  - It is necessary to address project assurance and ensure that any risks associated with the consolidation are known and addressed as well as that the consolidation is well-managed.
The United States Case Study – Partial Decentralization

The city of Austin, Texas, chartered in 1839, has a council-manager form of government with a mayor and six council members. The mayor and council members are elected at large for three-year staggered terms with a maximum of two consecutive terms. The city manager, appointed by the city council, is responsible for managing all city employees and the administration of city affairs with the exception of the city auditor, city clerk, municipal court, and municipal court judge.

The city provides a full range of services, including general government, public safety, transportation, planning and sustainability, public health, public recreation and culture, urban growth management, electric, water, wastewater, airport, convention, and other enterprise services.

Government Organization

City government is organized into six separate operating groups that comprise multiple departments within each group (as shown below). Each group is headed by an assistant city manager, including the city manager’s chief of staff.

- **Financial and Administrative Services**
  - Chief Financial Officer
  - Treasury
  - Budget
  - Purchasing
  - Controller of contract land management
  - Convention center
  - Communications and technology management
  - Human resources/labor relations

- **Development Services**
  - Economic Growth and Redevelopment Services Office
  - Planning and Development Review
  - Sustainability Office
  - Watershed protection
  - Real estate services
  - Aviation
• **Infrastructure Services**
  - Austin Water Utility
  - Capital Planning Office
  - Public Works
  - Austin Resource Recovery
  - Transportation

• **Community Services**
  - Animal Services
  - Health and Human Services
  - Library
  - Neighborhood Housing and Community Development
  - Parks and Recreation

• **Public Safety**
  - Code compliance
  - Community court
  - Emergency medical services
  - Medical director
  - Fire
  - Homeland security
  - Police

• **Chief of Staff**
  - Building services
  - Public information
  - Small and minority business resources
  - Fleet services
  - Governmental relations

There are also direct reports to the city manager, and to the city council (as mentioned above):

• **Direct Reports to City Manager**
  - Austin Energy
  - Police monitor
  - Law department
- **Direct Reports to City Council**
  - City auditor
  - City clerk
  - Municipal court/judges

**Decentralized Audit and Assurance**

The city auditor also is appointed by the city council for a term of five years and is required by ordinance to follow Generally Accepted Governmental Auditing Standards (GAGAS). In addition to the office of the city auditor (OCA), the city also has several audit and assurance entities appointed by department and enterprise heads. OCA and the other audit and assurance entities also conform with the Standards.

**City of Austin Audit and Assurance Entities**

<table>
<thead>
<tr>
<th>DEPARTMENT</th>
<th>TITLE</th>
</tr>
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<tbody>
<tr>
<td>Austin Energy</td>
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<td>Internal Auditor Senior</td>
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<td></td>
<td>Regulatory Auditor Senior</td>
</tr>
<tr>
<td></td>
<td>Audit Manager</td>
</tr>
<tr>
<td>Austin Water</td>
<td>Manager, Regulatory Audit</td>
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<tr>
<td></td>
<td>Regulatory Auditor Senior</td>
</tr>
<tr>
<td>Aviation</td>
<td>Manager, Airport Bus Enterprise</td>
</tr>
<tr>
<td></td>
<td>Performance Consultant</td>
</tr>
<tr>
<td></td>
<td>Business Process Consultant Senior</td>
</tr>
<tr>
<td>Convention Center</td>
<td>Department Quality Analyst</td>
</tr>
<tr>
<td>Construction and Land Management</td>
<td>Department Quality Analyst</td>
</tr>
<tr>
<td>Financial Services (TARA)</td>
<td>Department Quality Analyst</td>
</tr>
<tr>
<td>Health and Human Services</td>
<td>Department Quality Analyst</td>
</tr>
<tr>
<td>Human Resources</td>
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<td>Parks and Recreation</td>
<td>Department Quality Analyst</td>
</tr>
<tr>
<td>Solid Waste Services</td>
<td>Department Quality Analyst</td>
</tr>
</tbody>
</table>
Planning

The decentralization of auditing is a dynamic process. The approach comprises five steps.

**Step 1:** **Evaluation of need.** The existing city organization was — and is — evaluated by the OCA and city management to determine how to best organize an effective audit and assurance environment. This includes evaluating for risks that would lend themselves to needing an audit/review to address specialized audit topics. Examples considered were contract audits of city vendors in specialty areas (e.g., utility, aviation, vendor revenue), and other audits that can be more effectively and efficiently conducted by specialty auditors.

**Step 2:** **Validation and creation of special audit and review groups.** In addition to the existing internal audit activities at the two utilities, other assurance service needs were identified in other departments.

**Step 3:** **Reevaluating the other assurance activities.** A current effort is underway to determine what other activities should be converted into internal audit activities.

**Step 4:** **Creation of an audit and assurance committee.** This committee assists in facilitating effective collaboration to avoid duplication of efforts as well as provide pathways where each unit would be able to rely on the work of the other audit activities and where centralized efficiencies can be realized. This includes, but is not limited to, coordinated development of professional standards policies, training, and computerized audit tools.

**Step 5:** **Creation of a quality assurance coordinator.** A quality assurance activity was created in the OCA to provide ongoing reviews of the various auditing and assurance activities in the city. The results of those reviews will be presented to the individual boards, or to the department head, as appropriate.

Principles Applied to the Decentralization

A set of principles were applied when developing the decentralized structure.

- The overall responsibility for governmental auditing for the city and city management remains with the city auditor.
Internal audit activities can be considered for those departments or enterprises that have specialty, or specific, needs that are best addressed by specialty auditors, such as regulatory, revenue, contract, and other auditors.

All departments desiring to create an audit and assurance office and use the title of internal auditor or auditor should be required to follow the Standards as well as standards mandated by laws, regulations, ordinances, etc. Human resources and city management coordinate with the OCA when proposing the creation of an auditing activity and the use of any title including the word auditor. All decentralized offices are subject to audit by the city auditor to ensure that audit quality and standards are adhered to in accordance with the Standards and all other applicable standards.

Even in a decentralized environment, there are benefits to having a coordinating organization where all activities are represented.

**Experience to Date**

The experience has been beneficial and resulted in other actions and lessons learned:

- Other audit offices are being considered.
- There is an increasing awareness and acceptance of the control environment and of management’s responsibilities.
- A dotted line or other closely coordinated structure is ideal. Clear goals, responsibilities and roles, and planning should be defined.
- Planning should be coordinated to avoid duplication and gaps in audit coverage.
- Embedded auditors are more effective and efficient in auditing external vendors because of their proximity to operations.
- There is a need to evaluate the reporting structure of the various audit activities to ensure adherence to the Standards, and other applicable standards.

Responsibilities for audit committees or the top of the auditor’s reporting structure should be well-defined.

**Conclusion**

There are several reasons for restructuring. For example, there are often political, fiscal, and organizational considerations. Generally, economy and efficiency are key benefits identified of centralization, and effectiveness is the key benefit identified of decentralization. But it is not always that clear.

Politics, available skilled resources, a means to gain control of dysfunctional organizations, response to scandal or citizen discontent, etc., can all impact the appropriate
structure of an audit function. At times the benefits can actually switch back (i.e., de-
centralization might be more economical). Or, a rapidly expanding organization cannot
maintain itself using a centralized basis. Or, at times an expanding organization should
centralize to gain control and impose a uniform culture.

The bottom line is that each organization has to look at its unique situation and decide
what organizational structure is best.

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