

REPORT TO: AUDIT SUB-COMMITTEE 24 SEPTEMBER 2001
REPORT ON: A JOB WORTH DOING: RAISING THE STANDARD OF INTERNAL AUDIT
IN SCOTTISH COUNCILS
REPORT BY: AUDIT SCOTLAND
REPORT NO: 837-2001

ITEM 1

PERFORMANCE AUDIT

A job worth doing

Raising the standard of internal audit in Scottish councils

EXECUTIVE SUMMARY



The Accounts Commission

The Accounts Commission is a statutory, independent body, which through the audit process, assists local authorities in Scotland to achieve the highest standards of financial stewardship and the economic, efficient and effective use of their resources. The Commission has five main responsibilities:

- securing the external audit
- following up issues of concern identified through the audit, to ensure satisfactory resolutions
- reviewing the management arrangements which audited bodies have in place to achieve value for money
- carrying out national value for money studies to improve economy, efficiency and effectiveness in local government
- issuing an annual direction to local authorities which sets out the range of performance information which they are required to publish.

The Commission secures the audit of 32 councils and 34 joint boards (including police and fire services). Local authorities spend over £9 billion of public funds a year.

Audit Scotland

Audit Scotland is a statutory body set up in April 2000, under the Public Finance and Accountability (Scotland) Act 2000. It provides services to both the Auditor General for Scotland and the Accounts Commission. Together they ensure that the Scottish Executive and public sector bodies in Scotland are held to account for the proper, efficient and effective use of public funds.

Audit Scotland prepares reports for local government on behalf of the Accounts Commission.

The Commission welcomes comments and enquiries about its reports. Comments on this report should be directed to John Lincoln, Martin Christie or Douglas Black, in Performance Audit, Audit Scotland.

Acknowledgements

We would like to thank the study's Advisory Group, comprising a range of experts from councils and other bodies. The Group provided valuable advice and acted as a useful sounding board for the study team. Thanks also to the panel of external auditors who assisted us during the course of the study and in undertaking the peer review of councils' assessments.

The Accounts Commission takes sole responsibility for the contents of this report.

Key points

The study assessed the level of councils' compliance with the CIPFA Code of Practice for Internal Audit in Local Government ...

- ... when assessed against the CIPFA Code, we found that there is room for improvement in all councils, but some performed significantly better than others.
- ... Comhairle nan Eilean Siar, East Ayrshire, East Renfrewshire and West Lothian almost fully complied with the Code.
- ... Argyll & Bute, East Dunbartonshire, Inverclyde and Shetland complied with fewer than half of the standards in the Code.
- ... almost two thirds of councils (20) complied with more than 70% of the standards in the Code.

Councils invest £9.3 million a year in internal audit services, employing 265 staff ...

- ... there is considerable variation in the number of internal audit staff employed among councils of similar size.
- ... every Scottish council has its own internal audit service resourced by in-house staff. This contrasts with the NHS where consortia of in-house staff provide internal audit services to eight health board areas. The private sector provides internal audit services in the remaining seven health board areas.

Features most commonly found in the better performing councils, which were usually absent in the poorer performing councils, included ...

- ... the presence of an audit committee, or equivalent, to hold internal audit to account and ensure agreed audit recommendations are implemented.
- ... the use of comprehensive risk assessment to determine the council's internal control priorities and the work of internal audit.
- ... a richer skill-mix, which may be reflected in above-average unit staff costs, but not necessarily higher total audit costs.
- ... annual reporting by the chief internal auditor giving an overall assessment of internal controls.

All councils need to take action to improve ...

- ... effective internal audit sections can look forward to the challenges and opportunities presented by the greater use of audit committees, the proposals to introduce internal control statements, the growth in e-commerce, and Best Value.
- ... all councils should use this report, and their local external audit reports, to achieve full compliance with the Code.
- ... where the room for improvement is significant, there is a strong case for councils undertaking a fundamental appraisal of options for securing effective internal audit provision, including testing what the market might provide.
- ... external auditors will be monitoring council improvement actions.

Executive summary

Background

The Accounts Commission aims to ensure that all councils achieve the highest standards of financial stewardship, governance and public accountability. However, in recent years, there have been a number of instances where external auditors of councils have reported weaknesses in internal audit. The Commission requested Audit Scotland to carry out this national study to:

- establish a clear picture of the performance of internal audit services in all councils in Scotland
- provide benchmarking data to support continuous improvement.

Council performance was assessed against the standards set by the CIPFA Code of Practice for Internal Audit in Local Government.

Local authorities' investment in internal audit services

Every Scottish council has its own internal audit service resourced by in-house staff (with Comhairle nan Eilean Siar having a partnership agreement with a private sector firm to provide quality control). This contrasts with the NHS where consortia of in-house staff provide internal audit services to eight health board areas. The private sector provides internal audit services in the remaining seven health board areas.

The total amount invested in internal audit in all 32 Scottish councils is £9.3 million – about 0.1% of aggregate council expenditure. There are 300 full-time equivalent (FTE) established posts of which 265 were filled at the date of the study. Ten councils also provide internal audit services to other public bodies, for example, local police, fire and other joint boards. This work accounts for between 2-5% of total internal audit staff time in the councils concerned. There is considerable variation in the number of internal audit staff employed among councils of similar size.

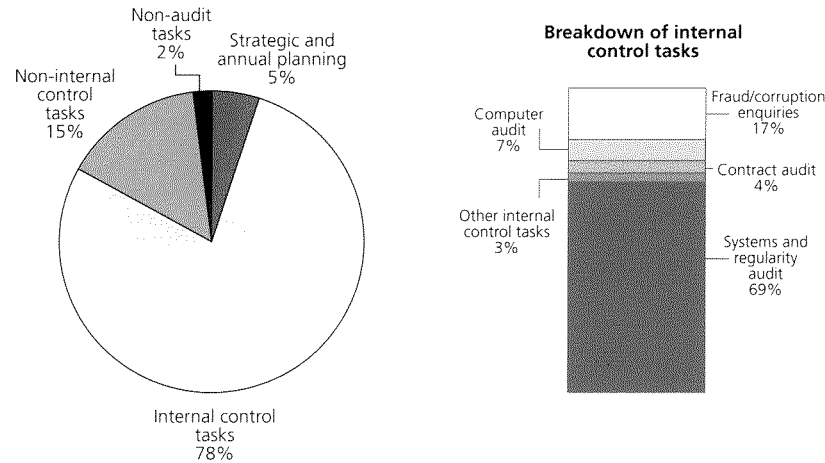
What internal audit does

Internal audit is an independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal control as a contribution to the proper, economic efficient and effective use of resources.

All internal audit sections undertake broadly similar types of work. This involves reviewing and testing the internal controls of key financial and non-financial systems, investigating any frauds or irregularities and, in some councils, specialist computer audit and contract audit work (Exhibit 1).

Exhibit 1: Internal audit workload

More than three-quarters of internal audit time is spent on internal control tasks.



Source: Local audit returns


How we assessed councils

The approach and methodology was developed in consultation with the study advisory group, the Scottish Local Authorities Chief Internal Auditors' Group, and a panel of external auditors. It involved identifying critical success factors for internal audit and establishing a framework of issues to be used in assessing the level of council compliance with the CIPFA Code.

Six critical factors were identified (Exhibit 2), with these being supported by 15 statements of good practice and 97 tests on individual council processes and outcomes (Exhibit 3).

Exhibit 2: Critical success factors

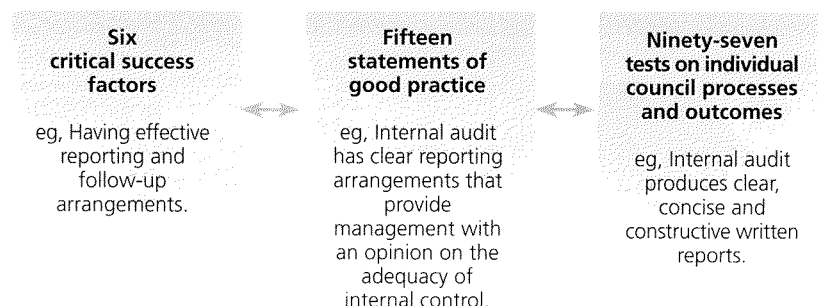
The study identified six critical success factors for internal audit.

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1. Setting clear and properly focused objectives for internal audit
 2. Maintaining internal audit independence
 3. Planning and controlling the work of internal audit
 4. Resourcing the internal audit work programme
 5. Having effective reporting and follow-up arrangements
 6. Holding internal audit to account for its performance

Source: Audit Scotland

Exhibit 3: Structure of the assessment

Fifteen statements of good practice and 97 tests on council processes and outcomes support the six critical success factors.



Source: Audit Scotland

External auditors conducted their independent assessments in February 2001, based on interviews and evidence gathered from each council's chief executive, director of finance and chief internal auditor. Client surveys of managers in education, housing, and social work services were also undertaken to obtain their assessment of internal audit performance in their service area.

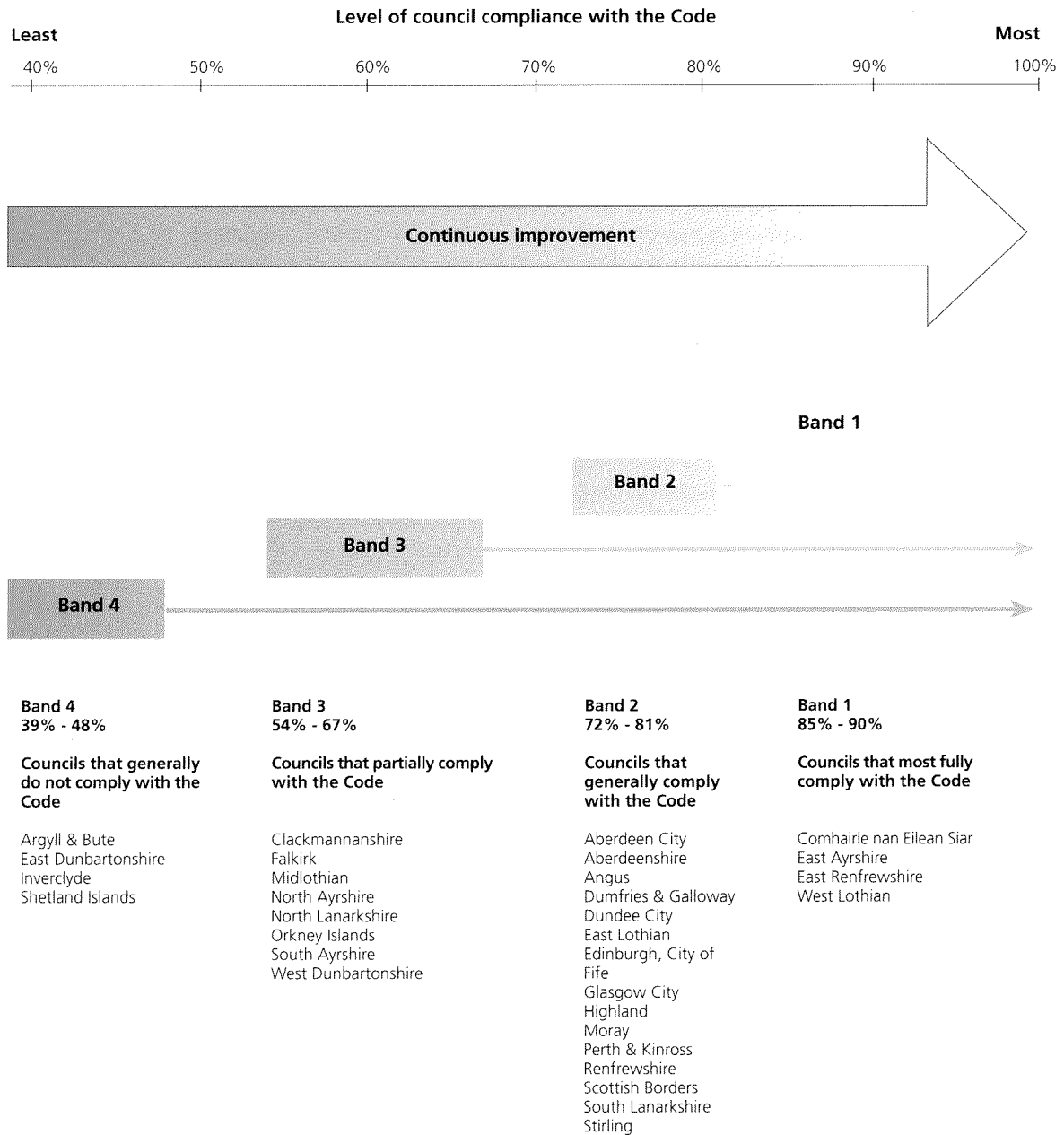
How councils performed

The study found that there is room for improvement in internal audit in all councils, but some councils perform significantly better than others (Exhibit 4). Councils are grouped according to their assessed level of compliance with the Code and listed in alphabetical order within the four performance bands. The better performing councils tend to perform well across the board, whereas councils in the lowest band of performance tend to perform poorly in most areas.

No council complied completely with the Code, but four councils – Comhairle nan Eilean Siar, East Ayrshire, East Renfrewshire and West Lothian were found to comply most fully (over 85% compliance). The councils with the lowest level of compliance with the Code were Argyll & Bute, East Dunbartonshire, Inverclyde and Shetland (below 50% compliance). Twenty councils complied with more than 70% of the standards in the Code.

Exhibit 4: Extent of council compliance with the CIPFA Code of Practice

All councils need to improve their compliance with the Code. Councils in bands 3 and 4 have the most to do.



Note: Councils are listed in alphabetical order within each performance band.

Source: Audit Scotland

The support and commitment of councillors, senior management, particularly the director of finance and chief executive, are key factors in developing an effective internal audit service. Some features most commonly found in the better performing councils, which were usually absent in the poorer performing councils, included:

- The presence of an audit committee, or equivalent, to hold internal audit to account and to ensure agreed audit recommendations are implemented.
- The use of comprehensive risk assessment to determine the council's internal control priorities and the work of internal audit.
- A richer skill-mix, which may be reflected in above-average unit staff costs, but not necessarily higher total audit costs. There is a significant correlation between the assessment score and the cost per audit day ($r^2 = 0.49$).
- Annual reporting by the chief internal auditor giving an overall assessment of internal controls.

The assessments highlighted a number of areas where improvement actions are required in a significant number of councils. For example:

- In 15 councils, the line-management arrangements for chief internal auditors did not comply with the Code (ie, their line manager was at a lower organisational level than the responsible finance officer). In these councils, there is a risk that the status and independence of the chief internal auditor may be compromised.
- In ten councils, internal audit did not maintain open channels of communication with members.
- 16 councils did not have defined control objectives for all major systems.
- 11 councils did not have an adequate anti-fraud and corruption strategy.
- Internal audit time spent on systems and internal control was more than 10% under-budget in 14 councils.
- 18 internal audit services did not use the results of follow-up work to update their risk assessment.
- In ten councils, the chief internal auditor did not co-ordinate and review the training and development requirements of their staff. In 13 councils, there was no induction programme for new staff.
- In nine councils, there was scope for chief internal auditors to further develop their use of performance indicators to measure the performance of their service.

The assessments also highlighted a number of areas of good practice. For example:

- Over 90% of service managers surveyed felt that internal audit recommendations were concise, clear and constructive.
- Service managers were generally satisfied with the time taken by internal audit to submit its draft and final reports.
- Internal audit generally had good working relationships with their external auditors, inspectorates and other review agencies.
- Standards of professional and ethical behaviour of internal audit staff were high across all councils.
- Five councils had independent accreditation (eg, ISO 9000 or 9002), which can assist in ensuring that the appropriate standards are in place.

Opportunities for the future

All internal audit services need to embrace a culture of continuous improvement, adopting proven best practice from other public sector and private sector organisations. Best Value and other initiatives are fundamentally changing the way councils work and this presents

opportunities as well as challenges for internal audit services. These include:

- **The introduction of audit committees and revised council structures.** Sixteen councils now have audit committees (or equivalent).
- **The changing role of internal audit.** Internal audit is emerging from its traditional 'policing' role to developing a more proactive corporate role. This changing role demands broader competencies than those of traditional audit services.
- **Expansion in the use of ICT.** The growing use of e-commerce and electronic signatures is placing greater demands on councils for expert skills in computer audit.
- **Getting improved value from council resources.** There is an opportunity for internal audit to develop new and improved ways of working to enable it to manage its resources more effectively.
- **The likely introduction of internal (financial) control statements (ICS).** These have been successfully introduced in other parts of the public and private sectors as a means of providing assurance to shareholders or stakeholders on the adequacy of internal controls within the organisation. The CIPFA LASAAC Joint Committee is actively considering the introduction of ICS to local government accounts.

However, in order to be able and well placed to meet these challenges councils need to ensure that internal audit is undertaking its core work effectively.

Challenging councils to improve

All councils have individual reports from their external auditor, assessing their level of compliance with the CIPFA Code of Practice. These show that some have a lot to do in raising their standards to those reflected in the Code. Each council is expected to implement the agreed recommendations contained in their external auditor's report.

Where the room for improvement is significant (particularly those councils falling within performance band 4), substantial progress is needed in a short space of time. There is a strong case for these councils testing current provision against what the market might provide. This would involve looking at options that would provide a high-quality service that ensures that the council's control objectives are met, at acceptable cost. These options would include:






- buying in specialist skills, for example, computer audit expertise
- entering into consortia arrangements with other councils
- partnership arrangements with the private sector
- externalising service provision.

Irrespective of who provides the service, the critical factors that underpin a Best Value internal audit service remain the same. All councils should be looking to develop sound internal control arrangements where:

- **councillors** are demonstrably committed to supporting the need for a sound internal control environment, including internal audit
- **senior managers** are demonstrably committed to maintaining effective internal controls and implementing sound internal audit arrangements
- **chief internal auditors** demonstrably provide an excellent internal audit service.

Exhibit 5 provides a checklist that highlights the key messages for an effective internal audit service. It should help councillors, chief executives, senior managers and chief internal auditors to ensure that their council has these arrangements in place. External auditors will be monitoring progress.

Exhibit 5: Achieving a Best Value internal audit service – a checklist for councillors, chief executives, senior managers and chief internal auditors

Critical factors	Key enabling factors
<p>1. Setting clear and properly focused objectives for internal audit</p> 	<ul style="list-style-type: none"> ■ Is the council committed to establishing an effective internal audit service? <input type="checkbox"/> ■ Does internal audit have clear terms of reference agreed by senior management and communicated these across the council? <input type="checkbox"/> ■ Does internal audit have a good understanding of the risks facing the council, developed in consultation with all service managers? <input type="checkbox"/>
<p>2. Ensuring that internal audit is independent</p> 	<ul style="list-style-type: none"> ■ Does internal audit have direct access to councillors, the chief executive and the director of finance? <input type="checkbox"/> ■ Does internal audit have (and is it seen to have) independence from operational procedures? <input type="checkbox"/> ■ Does internal audit have the right of final edit in submitting reports? <input type="checkbox"/>
<p>3. Making sure the work of internal audit is properly planned</p> 	<ul style="list-style-type: none"> ■ Does internal audit's planned work support the corporate objectives of the council? <input type="checkbox"/> ■ Does internal audit ensure that all planned work reflects the results from its systematic assessment of the council's risks? <input type="checkbox"/> ■ Does internal audit plan a sufficient contingency to accommodate unforeseen work, enabling it to complete its planned work within time-scale? <input type="checkbox"/>
<p>4. Making sure internal audit is adequately resourced</p> 	<ul style="list-style-type: none"> ■ Does senior management ensure that internal audit has the resources required to meet the internal control needs of the council? <input type="checkbox"/> ■ Does the council recruit and train suitably skilled internal audit staff? <input type="checkbox"/> ■ Has senior management given authority to the chief internal auditor to access specialist skills to tackle complex areas? <input type="checkbox"/>
<p>5. Ensuring that internal audit findings are reported and followed up</p> 	<ul style="list-style-type: none"> ■ Does internal audit report weaknesses in internal control for action by management? <input type="checkbox"/> ■ Does senior management systematically encourage all managers to implement report recommendations within agreed time-scales? <input type="checkbox"/> ■ Does internal audit report any failure by management to implement agreed recommendations? <input type="checkbox"/> ■ Does internal audit provide an annual report, providing an overall view on the soundness of the council's internal control systems? <input type="checkbox"/>
<p>6. Ensuring that internal audit is held to account for its performance</p>	<ul style="list-style-type: none"> ■ Does the council have an audit committee or equivalent to: <ul style="list-style-type: none"> – approve internal audit work plans? <input type="checkbox"/> – review internal audit's output and performance and ensure that it completes its programme of work? <input type="checkbox"/> – act as a conduit for receiving audit reports and call service managers to account? <input type="checkbox"/> ■ Does internal audit prepare annual performance plans, setting out its achievements and targets? <input type="checkbox"/> ■ Does internal audit maintain an effective performance management framework to continuously review and improve its performance? <input type="checkbox"/>