

# **Argyll and Bute Council**

## **Review of Internal Audit**

**May 2007**

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# 1 Executive Summary

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## Introduction

Internal audit is an assurance function that primarily provides an independent and objective opinion on the degree to which the internal control environment supports and promotes the achievement of the Council's objectives. 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. As such, it is a central element of the Council's overall governance arrangements.

The Code of Practice for Internal Audit in Local Government in the United Kingdom (the Code) issued by CIPFA in 2000 sets out good practice in delivering internal audit services. The Code has recently been revised to reflect the changing requirements and expectations of internal audit in local government.

We reviewed the Council's internal audit department against the eleven standards set out in the Code.

## Findings

Overall, we found that the Council is compliant with eight of the eleven standards set out in the Code as summarised below. In particular, we found that the Council has made significant progress in meeting Code requirements since Audit Scotland's national review of internal audit in 2001.

Standard	Fully Compliant
1 Scope of Internal Audit	✓
2 Independence	x
3 Ethics for Internal Auditors	✓
4 Audit Committees	x
5 Relationships	✓
6 Staffing, Training and Continuing Professional Development	x
7 Audit Strategy and Planning	✓
8 Undertaking Audit Work	✓
9 Due Professional Care	✓
10 Reporting	✓
11 Performance, Quality and Effectiveness	✓

However, we identified some areas where further work is required to reach full compliance with Code requirements, in particular:

- the resource assessment for the 2006-07 internal audit plan was not based on the resources actually available resulting in a resource shortfall for the year;
- Performance Development Reviews are not completed for internal audit staff in line with Council policy;
- three members of the internal audit department are currently seconded to the strategic finance department. This significantly reduces the resources available for internal audit work; and
- the findings from internal audit work are not routinely reported to the audit committee.

### The Way Forward

The findings and recommendations from our review are summarised in an Action Plan (Appendix A) which accompanies this report. The Action Plan has been agreed with management and incorporates the management response to audit recommendations.

The report includes some specific recommendations to strengthen internal controls. It is the responsibility of management to decide the extent of the internal control system appropriate to the Council.

### Acknowledgements

We would like to take this opportunity to thank the officers who have been involved in this review for their kind assistance and co-operation.

This report is part of a continuing dialogue between the Council and us and is not, therefore, intended to cover every matter which came to our attention. Our procedures are designed to support our audit opinion and they cannot be expected to identify all weaknesses or inefficiencies in the Council's systems and work practices.

The report is not intended for use by third parties and we do not accept responsibility for any reliance that third parties may place on it.

**RSM Robson Rhodes LLP**

**May 2007**

## 2 Scope of Internal Audit

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The Code requires that the Council formally defines the purpose, authority and responsibility of internal audit.

This includes:

- establishing terms of reference for internal audit, covering the key Code objectives;
- defining the scope and remit of internal audit and the process for determining how to allocate audit resources;
- defining any other work that internal audit may be required to undertake such as fraud or consultancy work; and
- defining internal audit's role in the prevention and detection of fraud or corruption.

The Council has included terms of reference for internal audit in an appendix to the Financial and Security Regulations (the Regulations). These set out the scope of internal audit, the role within the Council's operations and the department's mission statement. They also define the reporting lines between internal audit and those charged with governance. Internal audit are required to review the effectiveness of the control environment and to deliver an annual opinion on the adequacy of the Council's control environment.

Internal audit allocate audit resources by performing a risk assessment of each of the Council's core financial and non-financial systems over a three year period. The assessment considers the inherent risk associated with the nature of each system, the level of impact of any possible breakdown in the level of effective operation of the system, materiality factors assessing the financial size of the system and controls effectiveness based on the current level of assurance over the system controls and previous audit recommendations.

The Council's procedures for the prevention of fraud and corruption are detailed within the Regulations which includes guidance for staff reporting suspected fraud. The guidance states that all cases of fraud are reported to the head of strategic finance. The terms of reference do not specifically detail the role of internal audit in fraud investigations, however, the Regulations require that information on all frauds is passed to internal audit.

Our review found that internal audit are actively involved in any fraud investigations and report their findings to the senior management team and audit committee.

***Action plan point 1***

### Conclusion

The scope of internal audit work meets the requirements of the Code.

## 3 Independence

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Internal audit should be independent of the activities they audit to allow auditors to perform their duties in a way that allows them to make impartial, effective professional judgements and recommendations. This includes:

- maintaining an independent internal audit function with operational and organisational independence;
- appointing a head of internal audit with sufficient status within the Council;
- ensuring the independence of individual auditors and contractors; and
- establishing a process to declare conflicts of interest.

Internal audit's terms of reference state that auditors should not have operational responsibilities in order to maintain independence from the activities they audit. Our review found that three members of the internal audit team are currently seconded to positions within the strategic finance department. Each secondment was instigated at the request of the employee and will provide a significant development opportunity for the staff concerned. It is now unlikely that any of the secondments will return to internal audit.

Secondments from internal audit may compromise the independence of auditors should their return to the department not be effectively managed at the end of their secondment.

### ***Action plan point 2***

The Council does not operate with a single head of internal audit position. Internal audit is led by two managers although, in practice, one of the managers takes a lead role in the management of the department. In order to comply with the Code, the Council should formally designate a head of internal audit post. This would bring the Council in line with the majority of other Councils in Scotland, would raise the profile of internal audit and would help clarify reporting lines and responsibilities within the department.

### ***Action plan point 3***

The internal audit managers both report to the head of strategic finance, who is a member of the strategic management team. The terms of reference also enable the internal audit managers to report directly to the chief executive, the chair of the audit committee and elected members. These arrangements comply with the Code requirements.

A register of interests is maintained for all internal audit staff. Our review found that the register of interests is regularly reviewed and updated.

## **Conclusion**

The independence of the internal audit is not fully Code compliant as there is no formal process in place to ensure staff returning from secondment do not compromise the effective working and independence of the department. In addition, there is no formally designated head of internal audit position at the Council.

## 4 Ethics for Internal Auditors

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The Code sets out the minimum standards for the performance and conduct of all internal auditors. The Council should ensure all internal audit staff are regularly reminded of their ethical responsibilities with regards to:

- integrity;
- objectivity;
- competence; and
- confidentiality.

The Council's internal audit manual outlines the code of ethics for internal auditors including requirements for auditors in respect of integrity, objectivity, competence and confidentiality. In addition, those auditors who are members of professional accountancy bodies are obliged to adhere to the ethical standards required by their Institutes.

Conflicts of interest are officially recorded on the department's register of interests. Known conflicts are taken into account when allocating the audit work within the audit plan. The internal audit manager is aware of the need to strike a balance between rotating staff and allowing staff to build up knowledge of Council systems, although it is recognised that this is difficult given the size of the department.

### Conclusion

The internal audit department meets the Code's ethical standards.



## 5 Audit Committee

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The Code sets out recommendations for how internal audit should interact with the audit committee. The Council should ensure that:

- internal audit are represented at the audit committee;
- the audit committee reviews and formally approves the annual audit plan;
- outcomes from internal audit work are reported to the audit committee; and
- the progress of the annual audit plan is reported.

The internal audit manager attends all audit committees. In addition, there are regular informal meetings with the chair of the committee to ensure that key issues and findings are raised and discussed on a more regular basis.

The internal audit manager presents a progress update against the audit plan and a summary of all audit recommendations that should have been implemented, but remain outstanding to each audit committee. Officers are routinely required to attend the audit committee to explain why recommendations have not been implemented. These procedures represent good practice.

The Code requires the outcomes from internal audit work to be reported to the audit committee in sufficient detail to allow the committee to understand what assurance it can take from that work and/or what unresolved risks or issues it needs to address. The findings from internal audit work are currently not reported to the audit committee and this is not Code compliant.

***Action plan point 4***

The committee does not currently prepare an annual report to Council summarising its work during the year and outlining its view of the Council's internal control framework, risk management and governance arrangements.

***Action plan point 5***

### Conclusion

The Council does not fully meet Code requirements in relation to the operation of its audit committee as the work of internal audit is not routinely reported to the committee.

## 6 Relationships

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Internal audit will be involved a wide range of internal and external relationships. The quality of these relationships impacts on the effective delivery of the audit function, its reputation and independence. The Council should ensure that:

- internal audit work is co-ordinated with other parties to increase the efficiency of the audit process;
- good relations exist between internal audit and elected members and other Council officers; and
- good relations exist between internal audit, other inspectors and external audit.

It is important that the plans and activities of internal audit are co-ordinated with other parties to ensure optimal use of audit resource. Internal audit consult with external audit in the production of their annual audit plans. This represents good practice as both parties can plan and establish any areas where duplication can be avoided, and agree on areas to be subject to audit coverage.

The department's relationship with management is enhanced through the audit agreement document, which outlines the work to be performed, the dates for fieldwork and reporting audit findings. Both internal audit and each service under review sign the document. This approach also represents good practice in effective relationship management.

Internal audit has established dialogue with other regulators where appropriate, for example, providing support to HM Inspector of Education.

### Conclusion

The internal audit department meets Code requirements in managing its internal and external relationships.

## 7 Staffing, Training and Continuing Professional Development

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In order for internal audit to effectively deliver its plan, the Council should ensure that:

- the internal audit department is appropriately resourced to meet its objectives;
- there is an appropriate mix of qualified and non-qualified audit staff;
- skills and competencies are defined for each level of auditor; and
- all auditors are undertaking a programme of continuing professional development.

The internal audit department is staffed by three full-time auditors: two managers and one senior audit assistant. In addition, the partnership arrangement with KPMG provides audit resources for IT audit and management support.

There are currently three vacancies in the department due to auditors being seconded to other sections within Strategic Finance. The Council has appointed some part-time contractors to help fill the shortfall, however, internal audit is currently not fully resourced to meet its objectives.

***Action plan point 6***

The Council operates a Performance Development Review system for its employees which requires an annual appraisal. Internal audit staff do not, however, receive performance assessments. In addition, the skills and competencies required of each auditor grade are not defined and performance objectives are not made explicit. As a result, the future training and staff development needs of the internal audit department are not linked to a systematic needs assessment.

***Action plan point 7***

### Conclusion

The internal audit department is not currently Code compliant as it is not fully staffed to meet its objectives and internal audit staff have not been subject to formal annual appraisals.

## 8 Audit Strategy and Planning

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The Council has to consider how the internal audit service will be delivered and developed in accordance with the terms of reference and how it links to the organisational objectives and priorities. The Council should:

- produce an audit strategy detailing how the internal audit service will be delivered; and
- prepare a risk based audit plan designed to implement the strategy.

The Council has produced a three year strategy document which was approved by the audit committee in February 2005. The strategy sets out objectives and outcomes, how internal audit will provide their opinion on the control environment, how internal audit will address the significant local risks and how the service will be provided.

Internal audit work is prioritised on a risk basis and work is separately identified between core financial and non-financial reviews. These arrangements are Code compliant and in line with good practice.

The total audit days allocated to the 2006-07 audit plan included 555 days expected to be met by the three auditors who are on secondment and were unavailable for audit work at the time the plan was prepared. The Council appointed part-time contractors to cover the vacancies, however, a shortfall remained between the level of days provided by contractors and the agreed days contained in the plan. There is a risk that the audit plan cannot be delivered if the resource allocation is not based on a realistic assessment of the actual resources available.

**Action plan point 8**

### Conclusion

Internal audit has good strategic planning processes and adopts a risk based audit approach in line with Code requirements. A resource plan was prepared for the 2006-07 audit, but it did not fully reflect actual resource availability.

## 9 Undertaking Audit Work

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Internal audit are required to complete their work in line with the requirements of the Code. This includes:

- preparing a plan for each audit undertaken summarising objectives, scope and requirements;
- ensuring that all audit work is subject to an appropriate internal quality review process;
- ensuring that all audit work is supported by relevant evidence;
- ensuring that internal audit review their findings with senior management;
- specifying the required standard of internal audit documentation; and
- establishing standards and retention requirements for all audit documentation.

An audit briefing agreement is produced, discussed and agreed between internal audit and the relevant managers of the service for each audit undertaken. The audit brief summarises the objectives, scope and requirements of the audit. Our review found that the briefing agreements were being completed for each audit and were prepared in line with the Code objectives.

We reviewed work completed on the Council's core financial systems from the 2006-07 audit plan against the standards required in the Code. Our review found that audit files are set out in a standard fashion using the approved working papers and reporting templates disclosed in the Council's internal audit manual. We found a logical flow to the evidence on the audit files and issued reports. Files were subject to a detailed review either by one of the internal audit managers or KPMG in their management support role.

As a result of these findings, we are able to place reliance on the work of internal audit for the purposes of our audit.

For core financial system work, internal audit prepare detailed system notes detailing the stages in the relevant process and the associated controls. However, we noted that there is no walkthrough test performed to confirm that each stage of the process has been documented.

### ***Action plan point 9***

An 'access policy' is in place for all audit files and documentation, which requires individuals to sign and date a control sheet upon obtaining any audit file from the department. The internal audit manual specifies procedures for filing and retention of all audit documentation, both paper and electronic, and these are adhered to.

### **Conclusion**

Internal audit meet Code requirements in undertaking audit work.

## 10 Due Professional Care

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The Code describes due professional care as working with competence and diligence, using audit skills, knowledge and judgement based on appropriate experience, training (including CPD), ability, integrity and objectivity; and respecting and understanding confidentiality. The Council should:

- ensure internal audit complies with principles of due professional care;
- define the responsibilities of individual auditors in maintaining the principles of due professional care; and
- define the responsibilities of the Head of Internal Audit in maintaining the principles of due professional care.

The internal audit manual covers the principles of due professional care that all members of internal audit are expected to be adhere to. These include:

- maintaining confidentiality;
- declaring conflicts of interest;
- not accepting gifts, hospitality or inducements;
- being alert to any possible wrongdoing or fraud; and
- using all reasonable care in obtaining sufficient, relevant and reliable evidence on which to base their conclusions and recommendations.

Our review found that internal audit comply with these aspects of its manual in its operations. Good practice areas included the maintenance of a 'register of interests' for internal audit staff.

### Conclusion

Internal audit meet Code requirements in applying due professional care in their work.

# 11 Reporting

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The Code describes the primary purpose of internal audit as being to communicate to management information that provides an independent and objective opinion on the control environment and risk exposure and to prompt management to implement agreed actions. This requires the Council to:

- establish procedures for internal audit to report their findings;
- establish procedures for internal audit to follow up previously issued audit reports; and
- provide an annual internal audit report to those charged with governance to support the statement on internal control.

The Code requires internal audit reports to be accurate, clear, concise and constructive. We performed a review of internal audit reports against the requirements of reporting outlined in the Code. We found that internal audit reports generally meet Code requirements.

We noted that, whilst reports prompt management to implement agreed actions and provided a formal record of points arising from the audit, there is no explicit commentary within the report conclusions regarding the assurance awarded to the adequacy and operation of the system controls or area under review.

Internal audit provide management with an annual report summarising its work, key findings for the year and opinion on the effectiveness of the Council's internal financial control arrangements. There is scope to link this opinion more clearly to the overall assurance conclusion provided for each audit review.

***Action plan point 10***

Internal audit reports contain 'a summary of overall conclusions' section. The section assesses audit findings against the specific audit objectives and uses a system of 'ticks' graded from 1 to 5 in order to demonstrate how adequately arrangements are operating.

In some of the audit reports reviewed, the grading awarded in relation to controls assurance did not appear to correspond to the detailed findings within the audit report and the recommendations contained in the action plan. For example, the review of the Council's arrangements for leasing assets highlighted some significant internal control weaknesses in relation to compliance with accounting standards (for recording transactions) and standing orders (for the procurement process). However, the leasing system received a high rating which indicates that sound controls are operated.

***Action plan point 11***

Internal audit also prepare an annual audit report to 'those charged with governance' which is fully Code compliant.

Services are required to complete a questionnaire at the conclusion of each audit. The questionnaire includes five questions in relation to the format, style and accuracy of the audit report. Feedback indicated that Services are currently satisfied with the presentation of audit findings.

## **Conclusion**

Internal audit comply with Code requirements in their reporting arrangements. We found many areas of good practice, however, we also found some examples of inconsistency between audit findings and the overall assessment of arrangements.



## 12 Performance, Quality and Effectiveness

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The Council should ensure that the performance, quality and effectiveness of internal audit is regularly reviewed, including:

- drafting an internal audit manual in line with Code principles;
- establishing performance management procedures; and
- ensuring adequate supervision of staff.

The Council has an internal audit manual in place and provides guidance covering a number of areas including:

- responsibilities of internal audit and the code of ethics for internal auditors;
- relationships with clients and external audit;
- audit planning, audit programmes and quality management;
- value for money and best value audits; and
- working paper, file structure and reporting templates.

The internal audit manual was last updated in November 2003, following the introduction of the last Code. The responsibility for updating the manual is assigned to KPMG as part of the partnership agreement.

### ***Action plan point 12***

Internal audit operate good quality assurance systems by ensuring staff at all levels are appropriately supervised and working papers are subject to a detailed review.

Current procedures for performance management include seeking user feedback for individual audits via audit questionnaires and calculating performance against 11 performance indicator measurements. In line with the Code requirements, the results of the performance management programme are communicated in the annual audit report to the audit committee.

The Code requires that an overall quality review should be undertaken periodically to ensure that work complies with the Code and the manual. KPMG, under the terms of the partnership service agreement, provide an overall review of quality and report their findings annually.

### **Conclusion**

Internal audit meet Code requirements in their approach to performance, quality and effectiveness. However, the internal audit manual should be updated following revisions to the Code.

## Appendix A – Action Plan

No	Finding	Risk	Recommendation	Management Response	Responsible Officer	Implementation date
<b>Scope of Internal Audit</b>						
1	The Council's procedures for the prevention of fraud and corruption are detailed within the Financial and Security Regulations and include guidance for staff reporting suspected fraud. The guidance does not specifically detail the role of internal audit in fraud investigations.	Medium	The Council should update its 'guidance for staff reporting suspected fraud' to include specific reference to the role of internal audit.	The Council Constitution will be amended to recognise the role of internal audit in the investigation of suspected frauds.	Head of Democratic Services & Governance	April 2008
<b>Independence</b>						
2	Secondments from internal audit may compromise the independence of auditors should their return to the department not be effectively managed at the end of their secondment.	Medium	Wherever possible, the Council should ensure that internal auditors do not have any operational duties.  Internal audit should develop a policy for managing staff returning from secondment to ensure the effective working and independence of the department is not compromised.	Internal audit still do not undertake operational duties. However, it is beneficial to allow internal audit staff to gain a broader understanding of the Council where they apply and are successful in securing secondments.  Internal audit will produce a policy whereby seconded staff will not cover areas in which they have been involved for the next 2 years.	Head of Strategic Finance	July 2007

No	Finding	Risk	Recommendation	Management Response	Responsible Officer	Implementation date
3	The Council does not operate with a single head of internal audit position. This does not comply with the Code which recommends the appointment of a 'head of internal audit'.	Medium	The Council should formally designate a head of internal audit post. This would raise the profile of internal audit and would help clarify reporting lines and responsibilities within the department.	This situation will be reviewed at the end of the internal audit partnership.	Head of Strategic Finance	April 2008
<b>Audit Committee</b>						
4	The findings from internal audit work are currently not reported to the audit committee.	High	Internal audit work should be reported to the audit committee in sufficient detail to allow the committee to understand what assurance it can take from that work and/or what unresolved risks or issues it needs to address.	A report will be submitted to the next audit committee outlining the options regarding the reporting of internal audit work. This will range from full copies and reports to executive summaries and action plans.	Head of Strategic Finance	July 2007
5	The audit committee does not prepare an annual report to Council summarising its work during the year and outlining its view of the Council's internal control framework, risk management and governance arrangements.	Medium	The audit committee should consider preparing an annual report to the Council summarising its work during the year and outlining its view of the Council's internal control framework, risk management and governance arrangements.	This will be put to the first audit committee with a view to submitting a report to the Council in April 2008.	Chairman HOSF	April 2008
6	There are currently 3 vacancies in the internal audit department. The Council has appointed some part-time contractors to help fill the shortfall, however, internal audit is currently not fully resourced to meet its objectives.	High	The Council should ensure internal audit are fully resourced to meet objectives.	The recruitment process will commence in the next few weeks with a view to staff being in place by September 2007.	Head of Strategic Finance	September 2007

No	Finding	Risk	Recommendation	Management Response	Responsible Officer	Implementation date
<b>Staffing, Training and Continuing Professional Development</b>						
7	Internal audit staff do not receive annual performance assessments in line with Council policy. The skills and competencies required of each auditor grade are not defined and performance objectives are not made explicit. As a result, the future training and staff development needs of the internal audit department are not linked to a systematic needs assessment.	High	The Council should ensure that all staff receive an annual appraisal in line the requirements of the Performance Development Review (PDR) and define the skills and competencies required of each level of auditor. The annual appraisal process should act as a prompt for future training needs and aid staff development.	PDRs will be reintroduced for all members of staff within internal audit.	Internal Audit Manager	July 2007
<b>Audit Strategy and Planning</b>						
8	The total audit days allocated to the 2006-07 audit plan included 555 days expected to be met by the three auditors who were on secondment and unavailable for audit work at the time the plan was prepared. There is a risk that the audit plan cannot be delivered if the resource allocation is not based on the actual resources available.	High	The resource requirement calculation for audit planning should reflect the actual audit days available based on the current capacity of the department.	The annual audit plan for 2007/08 stated that there were vacancies and that they would be covered by contract staff. There will be a continuous review and reporting of the situation to the audit committee.	Internal Audit Manager	Done
<b>Undertaking Audit Work</b>						
9	Our review of internal audit's work on core financial systems found that detailed system notes were produced for each audit undertaken. We noted that there was no walk through test performed to confirm that the system was operating as documented.	Low	Audit documentation should include a walk through test to confirm that controls are operating as per the systems notes and flowcharts on file.	This will be done in 2007/08.	Internal Audit Manager	Immediate

No	Finding	Risk	Recommendation	Management Response	Responsible Officer	Implementation date
<b>Reporting</b>						
10	Internal audit provide management with an annual report summarising its work, key findings for the year and opinion on the effectiveness of the Council's internal financial control arrangements.  There is scope to link this opinion more clearly to the overall assurance conclusions reported for each audit assignment.	Low	Internal audit's conclusion on the effectiveness of the Council's internal financial control arrangements should be more clearly supported by the overall assurance conclusions reported for each audit assignment.	This is done in the 'overall conclusion and assessment against objectives' section. This gives assessment of 1-5 ticks.	Internal Audit Manager	Done
11	In some of the audit reports, the grading awarded in relation to controls assurance did not appear to correspond to the detailed findings within the audit report and the recommendations contained in the action plan.	Medium	The Council should ensure that the rationale for awarding a high controls assurance grading is clearly reflected within supporting working papers.	This will be covered in the Audit Manager review of the working papers file.  Auditees responses are also taken into consideration.	Internal Audit Manager	Immediate
12	The internal audit manual was last updated in November 2003. The responsibility for updating the manual is assigned to KPMG as part of the partnership agreement.	Medium	It is recommended that the Manual is updated to reflect the requirements of the 2006 Code of Practice. The Manual should be reviewed following each revision to the Code.	This will be done in conjunction with KPMG.	Internal Audit Manager	July 2007