

*Review of Internal Audit Service:
Report for Argyll and Bute Council*

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1. Purpose

1.1 The purpose of this report is to advise the Council regarding its internal audit service. My remit is to review the current structure, resources, tasks and reporting arrangements for the internal audit function, through analysis of existing documentation, consultation with users and staff, benchmarking with comparable authorities and to assess the options for development. The approach meets the principles of the Executive's Best Value initiative.

1.2 This report sets out my findings and recommendations for change. Our initial agreement suggested the final report would take account of Audit Scotland's national VFM study and local audit guide, but there has been some slippage with that timetable, and it is not yet in the public domain. I have, however, had access to the draft report, which is mainly concerned with matters of professional practice. I propose, therefore, to produce a supplementary report for the Council assessing the implications of the national report when it is available.

1.3 I am comfortable working within the context of Best Value principles for the review. Best Value is not a new approach, but one which builds on the corporate planning, VFM and competitive tendering experience of the past, and formalises them into a statutory requirement. It advocates a rational management framework with objectives, options and performance

management, using techniques and concepts such as clear service specification and performance monitoring, with a new emphasis on continuous improvement.

1.4 I am less comfortable with some of the assumptions and language of the BV advocates, which often assumes that a perfectly consistent hierarchy of objectives is feasible. Authorities are complex organisations which can be more rational, but not fully rational, and judgement remains necessary as information will remain imperfect. Language such as 'stakeholders' or '4Cs', is slick consultancy speak, and I prefer clear, simple language which sets out the arguments, issues and evidence on which recommendations are made. The four Cs – challenge, compare, consult and complete - simply mean that the review should demonstrate there is a need for the function; compare internal audit arrangements with authorities with similar characteristics; consult with clients of the service; and appraise the alternative means of delivering it. In theory, this approach could be comprehensive and time consuming, in practice I shall concentrate on the realistic options. The remainder of the report is structured around the four analytical elements of a Best Value review;

1.5 In completing the fieldwork and background research, I have been greatly assisted by members of the councils staff, the Accounts Commission and Price Waterhouse Coopers. The judgements and recommendations made, however, are my responsibility.

2. *The Need for an Internal Audit Function*

2.1 The first issue to address is the core one – is an internal audit function necessary. Authorities in England have a statutory duty to provide an internal audit function, but in Scotland, the statutory requirement is for every authority:

“to make arrangements for the proper administration of their financial affairs and shall secure that the proper officer has responsibility for their affairs”

2.2 Internal audit is widely regarded as an essential element of such proper administration in terms of professional practice, and CIPFA has issued an internal audit code of practice. The function is indeed a long standing one reflecting the British tradition of promoting probity in the management of the public finances, through ensuring authorities had efficient systems of accounting, authorisation and financial control; and that expenditure is legally incurred on approved services.

2.3 Some high profile examples of misuse of funds in the 1990s resulted in a renewed emphasis on promoting internal audit through the creation of audit committees as key mechanisms of sound corporate governance. The recent emphasis on Best Value has reinforced the need for internal audit, which has the skills to participate in BV reviews.

2.4 Internal audit is an independent appraisal function established by management to review the system of internal controls. To be effective it must be distinct from and independent of the institution's external audit provision, and should have no executive responsibility. Its primary focus is

on internal control systems, particular risk management, but IA can also undertake VFM studies and special investigations. The council will wish to ensure that it is receiving a service which meets professional standards; to establish and implement objectives and targets for the service (if these do not exist); and to compare its service with other authorities.

2.5 The need for independence is central to the status of Internal Audit, and their capacity to appraise the internal control system. The council will wish to be assured that its system of internal control gives a reasonable assurance that assets are safeguarded, waste or inefficiency avoided, reliable financial information produced, and value for money continuously sought. The internal control system is the whole system of controls, financial and otherwise, established to carry on the business of the council in an orderly manner, ensure adherence to council policies, safeguard its assets and secure the accuracy of records. This requires Internal Audit to adopt a systems-based approach to evaluation (a system is a set of related activities designed to operate together to achieve a planned objective).

2.6 It is not the function of audit to question policy, but it should consider the process by which decisions have been reached, and the mechanisms for meeting objectives. The council should wish to conform to the standards of *the public audit model* developed by CIPFA and supported by Audit Scotland, which requires arrangements which guarantee audit independence, and advocates a wider role and extended scope for audit. A good internal audit service is an important means of holding the executive and management to account, for their stewardship and use of public money. Increasingly, audit committees are being developed as the mechanism for

reporting such activity, and the Council has now established such a committee.

2.7 Audit Scotland in its Internal Audit Guide regards internal audit as an integral element of proper financial administration, to ensure propriety, regularity and value for money. Rigorous internal controls are needed to:

- ensure that the councils resources are applied in the manner, and on the activities intended;
- deter fraud and impropriety;
- ensure the effective use of resources.

Internal audit aids management by objectively examining, evaluating and reporting to management on the adequacy of internal control arrangements, and increasingly by participating in corporate working on promoting and implementing the Best Value initiative. In my view, an effective internal audit department works closely with departments in undertaking its functions.

2.8 The Controller of Audit has expressed continuing concern over the internal audit arrangements in Scotland's councils. His 1998-99 overview report found evidence of:

- *inadequate resourcing* of the internal audit function;
- involvement in *non-audit* work;
- *inadequate planning*;
- shortcomings in *reporting*;
- *inadequate access to specialists*, e.g. IT auditors

Its VFM study seeks to highlight such problems. His subsequent report found 'continuing weaknesses in basic accounting controls' four years after reorganisation. Sound financial procedures and effective controls are essential to proper financial stewardship of public funds. It is clear that the council would be failing in its fiduciary duty if it did not have an effective internal audit function, and that function requires appropriate resources and an appropriate quality of staff. Therefore, the case for local government continuing to provide such a function is overwhelming.

3. Benchmarking

3.1 All authorities have distinctive characteristics which affect spending and service delivery. For benchmarking purposes, and the broad judgements required in comparing authorities, it is better to concentrate on a few key variables. I have therefore selected three rural authorities of similar population size and poverty levels (see Table 1), the key factors which drive authorities activities and costs. At the request of one of those authorities, we have not identified them.

3.2 The Controller of Audit's report expressed concern over the adequacy of resourcing for internal audit purposes. An internal report has suggested that the council's *per capita* audit costs are around average for Scotland. We would expect the council's costs to be significantly higher as small rural authorities face diseconomies of scale. The councils position relative to the Scottish average, however, is of limited relevance in assessing the adequacy of its funding. Of greater value is a comparison with councils in similar

circumstances. The benchmarking exercise quantifies financial costs, the staffing positions, workload and range of tasks.

3.3 On costs, the council spends *less* per capita than two of the benchmark authorities; and the same as the third. To reach the average for the group, it would need to spend some £19k more. (see Table 2) It has less qualified staff but more support staff, and it undertakes more audit days than two of the benchmark councils. In last year's budget, the Council had to fund a further £69k of audit work from a private firm, because of staffing turnover and ill-health. This was funded at Audit Scotland rates, minus the overhead charge – net £280 per day, from savings elsewhere in the finance budget.

3.4 The main difference in the range of work undertaken is in VFM/BV analysis. One of the benchmark authorities includes a VFM perspective in all routine reports; whilst the other allocates 45 days. One authority allocates 55 days per annum to audit BV Review processes; the other expects BV work to develop. In the third authority, IA undertakes VFM work to assist with the corporate/departmental VFM programme. This requires 300 audit days, involving 1.5 FTE staff. The Five Year Plan however, recognises that the development of the Best Value regime may require further changes in the audit and VFM function. The section also provides 90 consultancy days to the Chief Executive and departments on referral from them.

3.5 In summary, Argyll and Bute spends less than its comparators; utilises less qualified staff; and concentrates on core audit work: Some

reconsideration of workload is clearly necessary, given the problems of staffing recruitment and retention the authority has faced in recent years, leading to criticisms from external audit over staff diversion into non-audit work.

4. Consultation

4.1 The Treasury and Cash Manager, the Support Services Manager, and the Amenity Services Manager were interviewed, and were generally favourably disposed towards Internal Audit, and its role was well understood. One interviewee defined it precisely –

‘The role of IA is to give guidance on financial systems and procedures, and to deal with internal fraud. Its approach is preventative, seeking to identify weaknesses and adapt accordingly, for if procedures are good, the prospect of risk decreases’.

4.2 The Chief Internal Auditor is highly regarded as having delivered improvements in a rigorous and professional way – leading to tightening of controls, and of handling ‘fraud’ cases well. The IA approach is informal, consultative and supportive, and they provide draft reports for discussion with departments before finalising the audit. The CIA was described as a “thinking auditor” who is being forced by circumstances to accept a more limited role. The IA approach was compared favourably with those of external contractors, who often ‘make impractical recommendations’, or list faults but fail to deliver ‘remedies and solutions’. The IA division should have a wider role in reporting findings from specific systems and spreading good practice across the authority. In practice, the CIA spends much of his time on *core audit* work, and less than is necessary on *managing* the function.

4.3 The IA staff by contrast felt they were of low status within the authority, in part due to their lack of experience, staff turnover etc, and that departments saw them as playing a regulatory role, rather than a consultancy role. Junior staff clearly have faced difficult problems in undertaking audit functions, but remain enthusiastic.

4.4 The staffing problems of IA are common to Finance as a whole, which uses four accountants on an agency basis. Unfilled posts put pressure on the work programme, and there is a continuing reliance on external staff.

5. *Options for Development*

5.1 These problems clearly have implications for the options open to the council in the future development of the service. The position is one of a lack of qualified staff with problems of retention; a lack of specialist skills necessary to develop the VFM/PI/BV initiatives; and underfunding of the service, but over-ambition in the workload. In the longer term, there would be benefits of direct provision, in terms of potential for wider corporate working, but given problems of recruitment, direct provision will remain problematic.

5.2 There are therefore *three* realistic options for service delivery; *direct provision*; *partnership*; or *outsourcing*. The key question is which of these will best meet the two key criteria for evaluation, namely the *cost* and *effectiveness* of service provision.

5.3 In terms of *cost*, the current budget is less than the comparator councils, in part because of the greater incidence of junior staff. Full outsourcing for the existing number of audit days would cost, at the Audit Scotland rates, over £300k. This could be reduced by cutting the number of days, but this might not allow the expansion of VFM//BV work which is desirable for the council's corporate development. Some councils outsource the *management* of the audit programme and others outsource core audit work. The comparator councils rely on direct provision.

5.4 In the short term, the only feasible approach is the *partnership* approach, with elements of the work contracted out, and elements undertaken in-house to permit the skills development which is essential. In the NHS, joint provision between boards on the basis of service level agreements is common, but not in local government. This may be a possibility in the longer term.

5.5 The council, therefore, needs a short term solution *and* a longer term strategy to tackle its recruitment problems. In the short term, it has little realistic alternative (given recent resignations) to continuing with a mixed economy of provision. The CIA should examine the existing workload, identify those tasks which internal audit do well and provide better VFM and then produce an audit plan that allows for some external support. This will have financial implications as private consultancy firms rates are more expensive than direct provision.

5.6 In summary, the council at the moment is underfunding the audit function relative to similar authorities. This, combined with staffing problems, has meant the work programme has not met the standards expected in the CIPFA Code of Audit Practice. Recommendations for improvement of audit practice will be made in the forthcoming Audit Scotland report. The council lacks access to VFM/IT skills in use elsewhere, and this deficit must be addressed. In the short-run, this can only be delivered in a partnership arrangement which includes a training dimension to develop the necessary managerial VFM and IT skills in the Council's staff in the longer term. External contractors bring benefits of wider knowledge of practice, but direct provision offers greater scope to promote corporate development. The *partnership* approach is the only feasible option in cost terms in the short-run. Moreover, the CIA should assess the overall training needs of his unit to assure the council it is meeting their training needs to secure a quality audit service.

6. *Conclusions and Recommendations*

6.1 There is a clear ongoing need for an internal audit function.

6.2 In contrast with comparator councils, Argyll and Bute commits less resources; employs fewer qualified staff; concentrates on core audit work; and lacks the VFM/BV skills necessary to meet new pressures.

6.3 The existing IA function is seen as an improvement on the past, and as having helpful and positive approach.

6.4 IA staff feel undervalued, and are inexperienced

6.5 There is little real alternative in the short term to continuing in a partnership mode with external contractors.

6.6 The research shows that the council is not deriving maximum benefit from the internal audit function, because of problems of recruitment and retention, and lack of qualified staff to undertake the emerging VFM/BV/IT work. In the years ahead, the Audit Committee will generate additional work for Internal Audit, including a role in advising the Committee on the implications of Accounts Commission VFM reports and on the adequacy of its BV regime. In addition, the council would itself benefit by IA participation in the Best Value Review Process to deliver improvements in efficiency and service delivery.

6.7 I would therefore advise the council to –

- (a) *increase* the IA budget by around £80k to allow improvements to be made, recognising that this will reflect the high cost of using private firms compared with direct provision in the short term.

- (b) *review* the IA plan, reducing the total number of core audit days; making provision for a VFM perspective in audit activity; and developing performance assessment and BV appraisal work. The council needs to identify a key player – possibly the CIA – who will develop the managerial and VFM/BV roles within the service.

- (c) *negotiate* a 3 year partnership agreement with an appropriate external contractor to ensure continuity of provision meantime; including managing the function, and some training in management/VFM/BV techniques.
- (d) *revisit* the issue in three years time, to assess whether partnership or direct service delivery is the way ahead for the council;
- (e) The CIA should continue as at present *to report* to the FD as his line manager, to maintain corporate identity, but must have the right to report directly to the Chief Executive and the Audit Committee, if in disagreement with the FD.

6.5 These changes will fulfil four pressing needs;

- strengthen the councils financial controls and enhance its BV work;
- reassure the community that the council recognises the need for sound arrangements in its financial arrangements;
- provide a positive response to the concerns of Audit Scotland; and
- demonstrate the council's commitment to Best Value principles to the Scottish Executive.

6.6 These recommendations will ensure that the council meets its statutory duty to secure the efficient administration of its financial affairs, and allow it to respond positively to the development of Best Value in future.

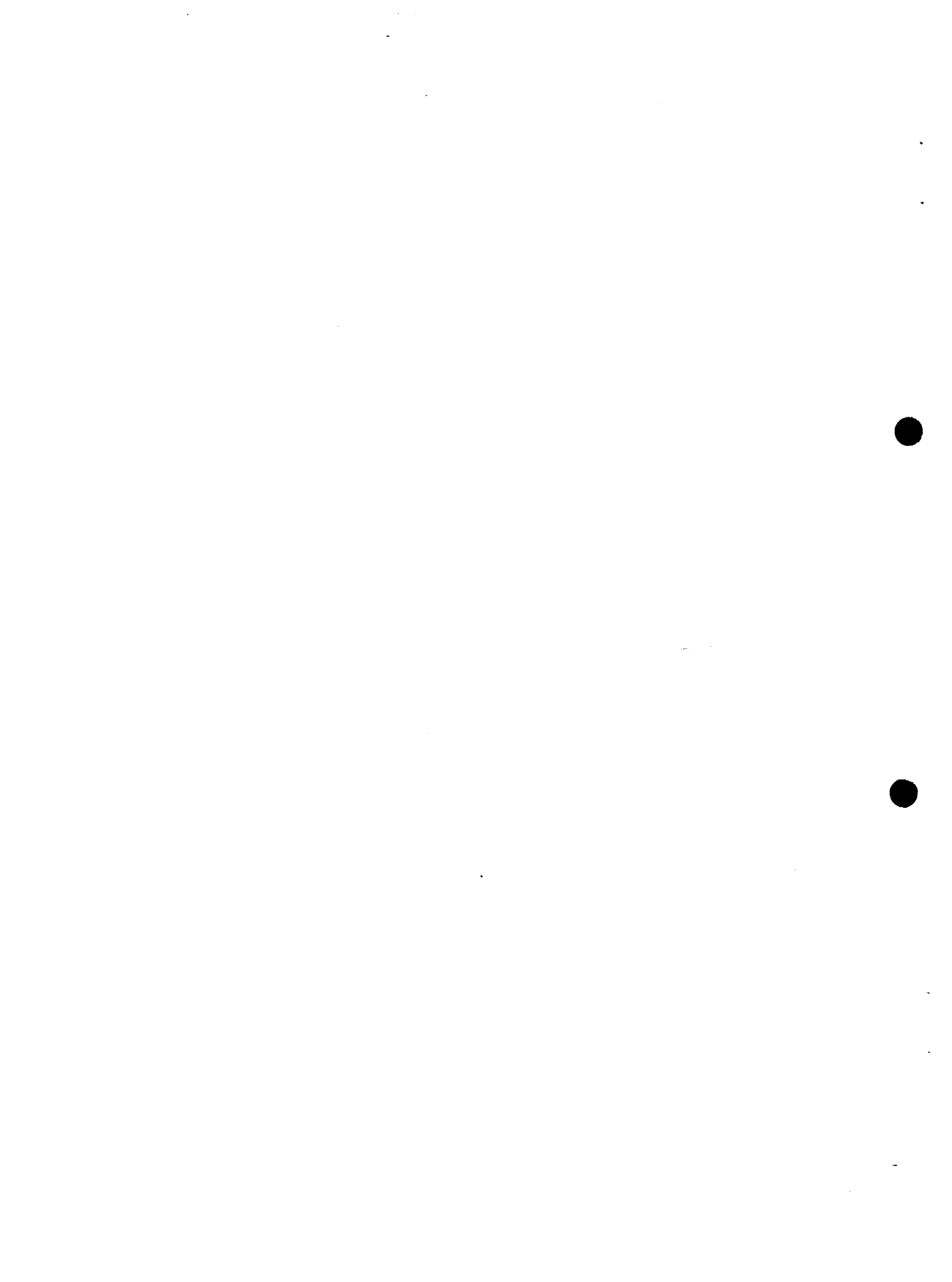


Table 1: Comparator Authorities

	Population	Sparsity*	Urban Lane Length	Income Support per person
Argyll and Bute	90,000	68.5	884	124
Council A	110,000	43.8	882	125
Council B	86,000	71.2	800	108
Council C	105,000	71.5	840	99

* Urban Settlement Pattern: % of population living in settlements <10,000 people.



Table 2: Comparative Data

	Costs per Capita (£)	Audit Days (Number)	Qualified Staff (FTE)
Argyll and Bute	1.87	1087	2 (1 vacant?)
Council A	2.30	1841	5
Council B	1.87	853	3
Council C	1.94	950	3
Weighted Average Of Comparator	2.04	1247	3.7

