

A job worth doing

Raising the standard of internal audit in Scottish councils
A follow-up report

Prepared for the Accounts Commission

July 2004



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.

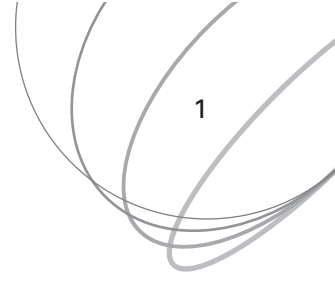
The Commission secures the audit of 32 councils and 34 joint boards (including police and fire services). Local authorities spend over £9 billion of public funds a year.

Acknowledgements

This report has been prepared by Audit Scotland on behalf of the Accounts Commission for Scotland. The study team consisted of Corrinne Forsyth and John Lincoln working under the general direction of David Pia, Director of Performance Audit (Local Government). We would like to thank councils' external auditors for undertaking their assessments of internal audit in a timely and professional manner.

Audit Scotland is a statutory body set up in April 2000 under the Public Finance and Accountability (Scotland) Act 2000. It provides services to 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.

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key findings



Councils have improved in all aspects of internal audit, but there is room for further improvement.

The study

In August 2001, the Accounts Commission report *A job worth doing – raising the standard of internal audit in Scottish councils* examined the internal audit arrangements in Scottish councils. This is a follow-up study which reports on the progress made by councils since 2001. The study compares external auditors' assessments of councils' compliance with the CIPFA Code of Practice for Internal Audit in Local Government (the Code) in 2004 with 2001.

Nearly all councils have improved their performance

Twenty-seven councils demonstrated a higher level of compliance with the Code than in 2001. In East Renfrewshire, one of the highest performers in 2001, compliance remained the same; in four councils (Dumfries & Galloway, East Lothian, Falkirk and Perth & Kinross), the level of compliance was slightly reduced.

Four councils (Angus, East Ayrshire, Highland and Renfrewshire) scored particularly highly (94% compliance or more).

The biggest improvement was in three of the four councils who were previously in the lowest performance band (Argyll & Bute, Inverclyde and Shetland Islands).

Councils have improved in all aspects of internal audit, but there is room for further improvement

Overall, performance improved in all aspects of internal audit. Councils did particularly well in the following areas:

- clear role in relation to fraud
- effective organisational status
- internal audit's independence and freedom from operational responsibilities

- management, control and recording of internal audit work.

But councils still need to improve in the following areas:

- basing their work on a comprehensive risk assessment
- more structured planning
- following up recommendations to ensure action is taken
- developing an effective performance management framework
- clarifying the respective roles of management and internal audit in maintaining internal control.

A higher proportion of internal audit staff now have a professional accountancy qualification

In 2001, a richer skill mix was most commonly found in better-performing councils. In 2004, a higher proportion of internal audit staff (55% in comparison with 45%) hold a professional accountancy qualification.

Councils working in partnership with the private sector performed well

In 24 councils, the internal audit service was resourced fully by in-house staff. In the remaining eight councils, some services were outsourced. In four of these, this related mainly to the provision of computer auditing. In the other four councils (Argyll & Bute, Eilean Siar, Inverclyde and Renfrewshire), partnership arrangements with the private sector had been put in place. These four councils are all now in the top performance band and 'almost fully comply' with the Code; two, (Argyll & Bute and Inverclyde), have moved from the bottom ('generally did not comply' with the Code) to the top performance band.

Two-thirds of councils still do not have audit committees operating fully under audit committee principles

Although all councils indicated that they have established an audit committee or equivalent, two-thirds do not operate fully under audit committee principles:

- a fifth do not consider the adequacy of management response to internal audit advice and recommendations
- a third do not consider the resourcing of internal audit or consider all internal and external audit reports
- nearly a quarter do not meet in public.

There is scope for internal audit to make a greater contribution to the internal financial control statement

In assessing how well prepared Scottish councils are in relation to the statement on the system of internal financial control (SSIFC), introduced in 2002/03, we found that:

- in four councils, the chief internal auditor did not provide timely information to those charged with governance to use in the preparation of the SSIFC
- half of councils did not clearly state in their internal audit strategy how they were going to provide assurance for the SSIFC.

Next steps

Councils should address the recommendations listed in Part 4 of this report. External auditors will prepare an individual report for each council, setting out their level of compliance with the CIPFA Code of Practice. Each council is expected to take action to address the issues contained in their external auditor's report.

Part 1. Introduction



The study

1. In August 2001, the Accounts Commission report *A job worth doing – raising the standard of internal audit in Scottish councils* examined the internal audit arrangements in Scottish councils. Council performance was assessed against the CIPFA Code of Practice for Internal Audit in Local Government (the Code). Councils were placed in one of four performance bands depending upon the extent to which they complied with the Code. The report made recommendations to councils on how to improve their internal audit service.

2. This is a follow-up study by Audit Scotland on behalf of the Accounts Commission. It reports how much progress councils have made since 2001. External auditors have assessed the extent to which all 32 councils were complying with the CIPFA Code in early 2004, using the 2001 study methodology.

3. This report sets out the main improvements made since 2001 and identifies the areas for further improvement. Recommendations are

made where council performance needs to improve. Specific details of improvement actions which need to be taken by individual councils can be found in their external auditor's local report and action plan. Each council is expected to take action to address these issues.

Internal audit

4. Scotland's councils are required to have in place arrangements for ensuring propriety, regularity and Best Value in their stewardship of public funds. It is the responsibility of management to ensure that adequate internal controls are in place to:

- ensure that their council's resources are applied in the manner and on the activities intended
- deter fraud and impropriety
- ensure the most effective use of resources.

5. Internal audit aids management by objectively examining, evaluating and reporting to management on

the adequacy of internal control arrangements.

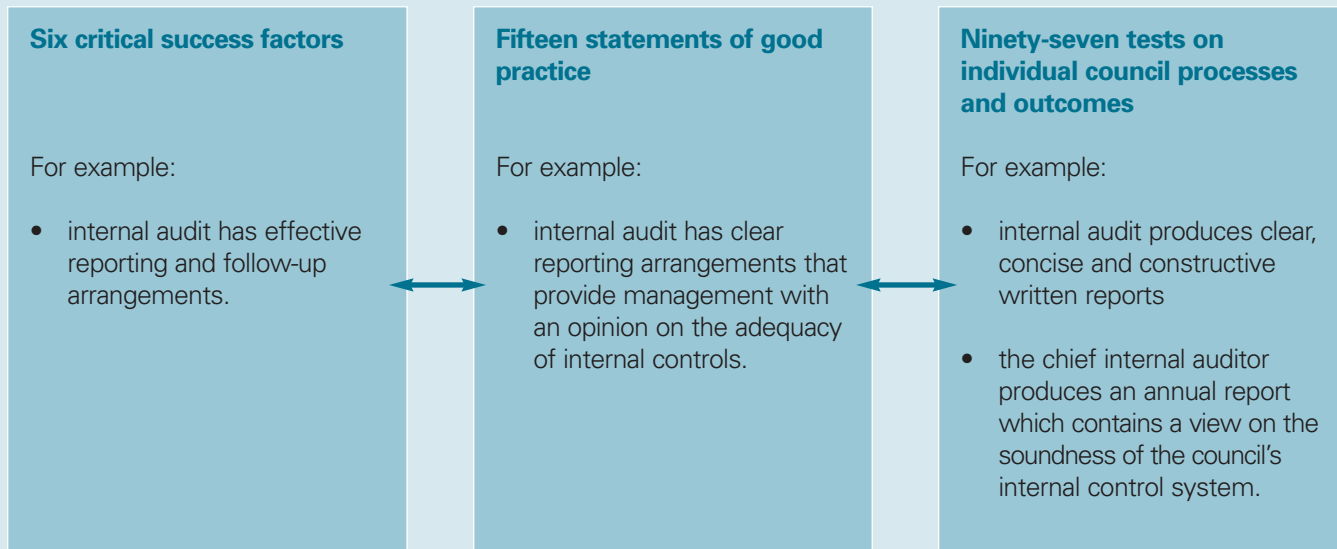
6. Since 2001, when the initial report was published, a number of developments have affected councils' arrangements for internal audit and the skills that internal auditors need to provide an effective audit service. From 2002/03, the Accounting Code of Practice (ACOP) required local authorities to include within their accounts a statement on their system of internal financial control. Internal audit services have a key role to play in producing evidence to support this statement.

7. Risk management has assumed a higher profile since the initial study and councils are increasingly expected to have effective audit committee arrangements. A new CIPFA Code of Practice for Internal Audit in Local Government, which takes account of these developments, was published in September 2003. Also, in June 2004, the CIPFA in Scotland Directors of Finance section produced a guidance note on audit committee principles in local authorities.

Exhibit 1

Structure of the assessment

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



Source: Audit Scotland

Study objectives and methodology

Objectives

8. The objectives of the study were to measure the progress since 2001:

- by councils across Scotland, particularly in the areas of concern identified in the initial study
- by individual councils, particularly those placed in the lower performance bands in the initial study.

Assessment methodology

9. The assessment methodology, used for both the initial and the follow-up studies, was developed in consultation with the Scottish Local Authorities Chief Internal Auditors' Group, a panel of external auditors and a study advisory group containing representation from the key stakeholder interests. The assessment framework was developed from the CIPFA Code of Practice for Internal Audit in Local Government, published in October 2000.

10. The following six critical success criteria were used to assess the extent to which each council's internal audit service met standards of good practice:

- setting clear and properly focused objectives for their work
- maintaining audit independence
- resourcing their work programme
- planning and controlling their work
- reporting and follow-up arrangements
- being accountable for their performance.

11. These six factors were supported by 15 statements of good practice and 97 tests on individual council processes and outcomes ([Exhibit 1 above](#) and [Exhibit 2 overleaf](#)). Each test was scored by external auditors on a scale between one and four. Overall results were aggregated and councils placed in one of four performance bands defined as:

- Band 1 – almost fully comply with the Code
- Band 2 – generally comply with the Code
- Band 3 – partially comply with the Code
- Band 4 – generally did not comply with the Code.

12. Councils' internal audit arrangements were reassessed by their external auditors in early 2004. Therefore, councils have had more than three years to put arrangements in place to comply with the Code.

Exhibit 2

The critical success factors and their linked statements of good practice

Councils' internal audit services were assessed against these statements of good practice.

Critical success factors	Statements of good practice
1. Setting clear and properly focused objectives for internal audit	<ul style="list-style-type: none"> 1. Internal audit has agreed terms of reference. 2. The respective roles of management and internal audit in maintaining internal control are clearly defined and communicated. 3. Internal audit has a clear role in relation to fraud.
2. Maintaining internal audit independence	<ul style="list-style-type: none"> 4. Internal audit has sufficient organisational status to be able to undertake its work effectively. 5. Internal audit is free of operational responsibilities that could compromise its independence.
3. Planning and controlling the work of internal audit	<ul style="list-style-type: none"> 6. Internal audit bases its work on a comprehensive risk assessment. 7. Internal audit operates within a structured planning framework. 8. Internal audit has effective relationships with council members, council managers, external audit, inspectorates and other agencies. 9. Internal audit properly manages, controls and records its work.
4. Resourcing the internal audit work programme	<ul style="list-style-type: none"> 10. Internal audit is adequately staffed and resourced. 11. Internal audit staff are suitably trained and developed.
5. Having effective reporting and follow-up arrangements	<ul style="list-style-type: none"> 12. Internal audit has clear reporting arrangements that provide management with an opinion on the adequacy of internal controls. 13. Internal audit follow-up their recommendations to ensure action is taken.
6. Holding internal audit to account for its performance	<ul style="list-style-type: none"> 14. Internal audit has a performance management framework that ensures continuous review of its performance. 15. The chief internal auditor promotes and maintains professional standards in internal audit.

13. The new CIPFA Code, published in September 2003 to take account of new Accounts and Audit regulations in England, has been radically restructured but is still based on the 1990 Auditing Practices Board (APB) guideline. To enable the measurement of progress by councils on a consistent basis, the reassessment for this study was based on the 2000 CIPFA Code. Additional questions covering the changes made in the 2003 Code, mainly in relation to audit committees and internal financial control statements, were added. This enabled auditors to assess the degree of change required in Scottish councils to meet the obligations of the new Code.

14. A detailed explanation of the assessment and scoring methodology can be found in [Appendix 1 \(page 25\)](#).

Structure

15. This report is in four parts. After this introduction (**part 1**):

- **part 2** – summarises the results of the external audit assessments. It highlights specific areas where there is scope for councils to improve internal audit performance. It also looks at the level of resources Scottish councils invest in internal audit

- **part 3** – summarises recent developments and the key actions that councils need to take to ensure that internal audit services are fit to meet the challenges facing them, in particular on audit committees and internal financial control statements
- **part 4** – sets out the conclusions and recommendations arising from the follow-up study.

16. The Appendices provide further information about the methodology and assessment scores.

Part 2. Assessment of internal audit performance



Overall findings

17. Councils' performance has improved since the previous study. The number of councils in the highest of the four performance bands has risen from 4 to 17 ([Exhibit 3](#)).

18. Twenty-seven councils demonstrated a higher level of compliance with the Code than in 2001. In East Renfrewshire, one of the highest performers in 2001, compliance remained the same; in four councils (Dumfries & Galloway, East Lothian, Falkirk and Perth & Kinross), the level of compliance reduced slightly.

19. Most councils improved their overall performance, but the extent of improvement varies significantly ([Exhibit 4 overleaf](#)). Councils placed in the lower performance bands in 2001 had more scope to improve. Also, in the better-performing councils in 2001, the more straightforward aspects of the Code will already have been implemented and improvement will therefore be more challenging. For example, East Ayrshire's improvement may appear to be relatively small, but relative to their initial position it is considerable.

Performance of individual councils

20. As shown in [Exhibit 4 \(overleaf\)](#), four councils (Angus, East Ayrshire, Highland and Renfrewshire) scored particularly highly (94% compliance or more). Seven others scored over 90%.

21. The biggest improvement was in three of the four councils who were previously in the lowest performance band (Argyll & Bute, Inverclyde and Shetland Islands). As a result, they now 'almost fully comply' with the Code ie, they are in the highest performance band.

22. [Appendix 2 \(page 28\)](#) contains a summary of each council's performance for each of the 15 statements.

Exhibit 3

Number of councils in each performance band

The number of councils in the top performance band has risen from 4 to 17.

Performance band	Number of councils	
	2004	2001
1. Almost fully comply	17	4
2. Generally comply	11	16
3. Partially comply	4	8
4. Generally did not comply	0	4

Source: External auditors' returns 2001 and 2004

Performance by internal audit area

23. Overall, scores improved in all aspects of internal audit ([Exhibit 5 overleaf](#)), but councils did particularly well in the following areas:

- clear role in relation to fraud
- effective organisational status
- internal audit's independence and freedom from operational responsibilities
- management, control and recording of internal audit work.

24. But councils still need to improve in the following areas:

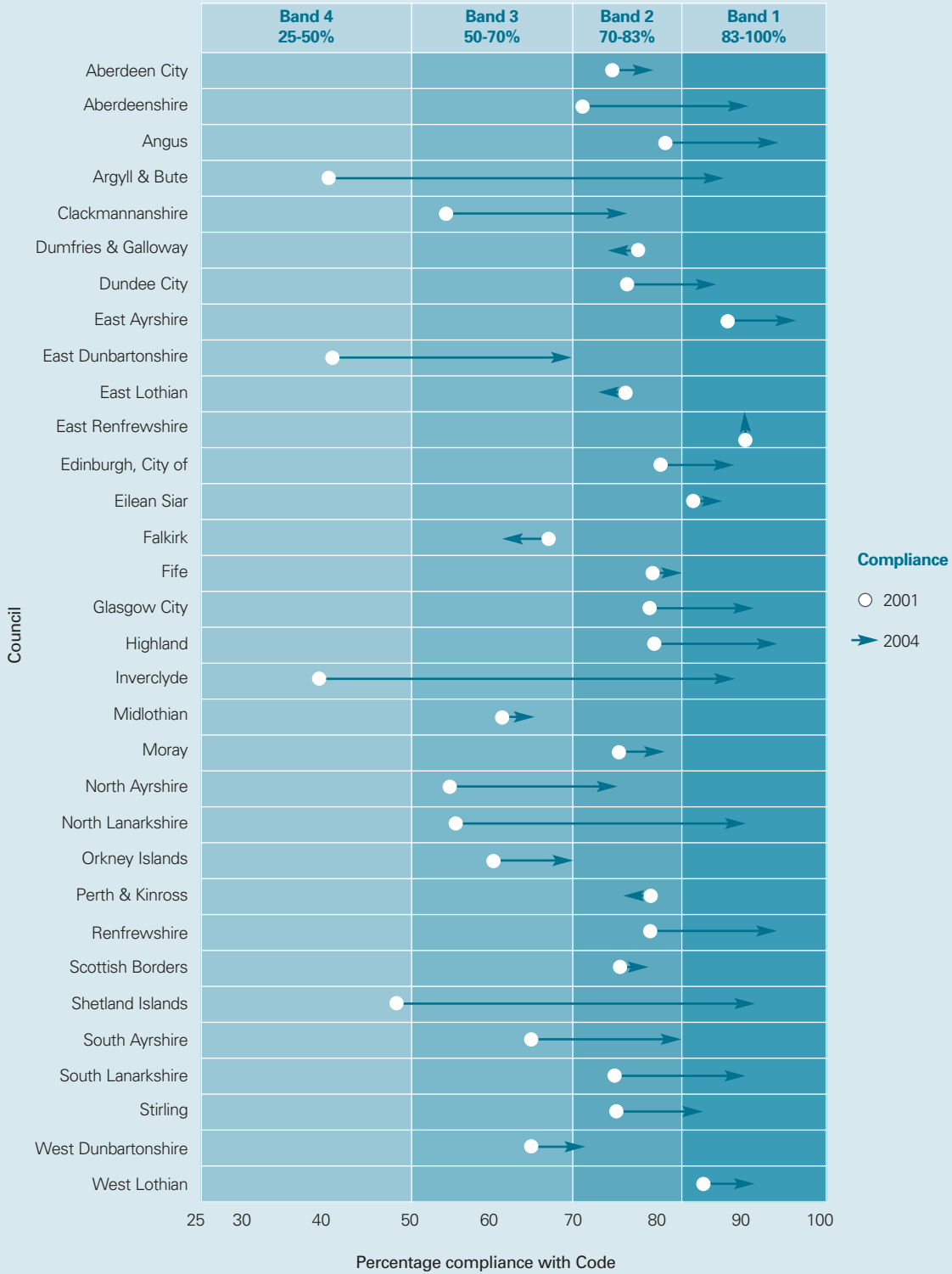
- basing their work on a comprehensive risk assessment
- more structured planning
- following up recommendations to ensure action is taken
- developing an effective performance management framework
- clarifying the respective roles of management and internal audit in maintaining internal control.

25. The remainder of this section is structured around the six critical success factors identified in the initial study. Figures in brackets which begin with '2001' relate to the position in 2001 when the initial report was published. For example, '19 (2001: 16) councils did not have defined control objectives for all major systems' means that 19 councils did not have defined control objectives for all major systems in 2004, compared to 16 in 2001.

Exhibit 4

Councils' improvement since the initial study

Councils originally in the lowest performance band have made the greatest improvement.

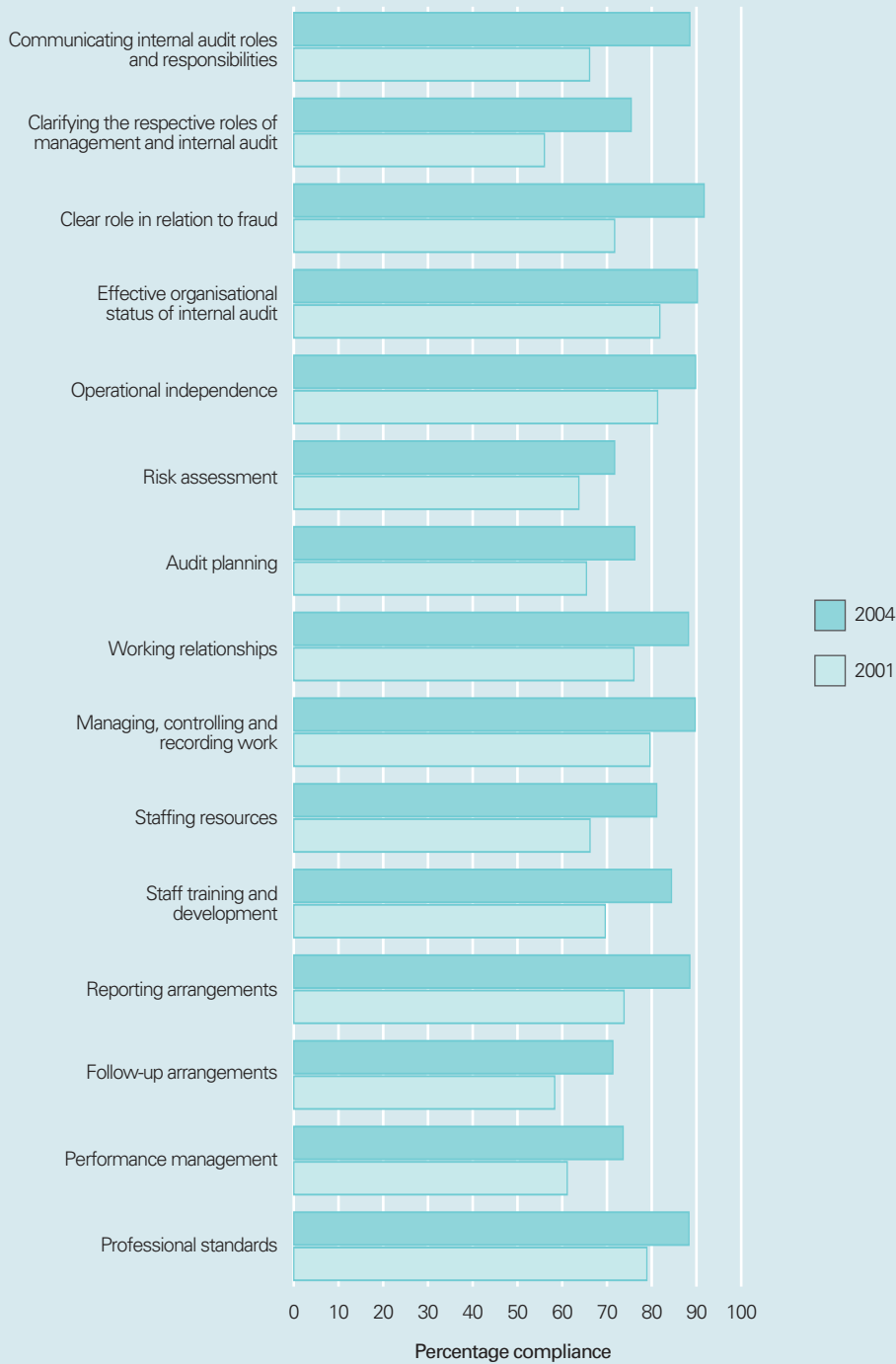


Source: External auditors' returns 2001 and 2004

Exhibit 5

Internal audit assessment scores – 2001 and 2004

Councils have improved in all areas, but further improvement is still needed in some.

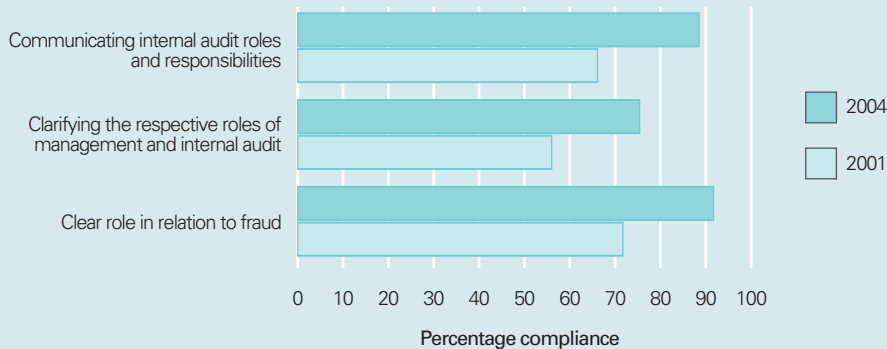


Source: External auditors' returns 2001 and 2004

Exhibit 6

Setting clear and properly focused objectives: Performance in 2001 and 2004

Performance in all three areas has improved. Clarifying the respective roles of management and internal audit remains the weakest of the three.



Source: External auditors' returns 2001 and 2004

Critical success factor 1 – Setting clear and properly focused objectives

26. It is important that the role and objectives of internal audit are made clear to internal audit and its clients. Staff must be clear about their roles and responsibilities, and management must be clear about their role in maintaining effective internal controls. This critical success factor is supported by three statements of good practice (Exhibit 6):

- communicating internal audit roles and responsibilities
- clarifying the respective roles of management and internal audit in maintaining internal control
- having a clear role in relation to fraud.

Communicating internal audit roles and responsibilities

27. Agreed terms of reference that are widely communicated across the council help to ensure that the role and objectives of internal audit are made clear to both internal audit and its clients.

28. External auditors found that:

- all 32 (2001: 23) councils now have written terms of reference for internal audit agreed between the chief internal auditor, senior management and councillors
- communication arrangements between members and the chief internal auditor are set out in the terms of reference or standing orders in 31 (2001: 16) councils
- in 13 (2001: 13) councils, the internal audit terms of reference do not take account of the council's corporate aims and objectives
- six (2001: 14) councils still do not have an internal audit charter or mission statement to communicate their roles and responsibilities across the council.

Clarifying the respective roles of management and internal audit in maintaining internal control

29. It is management's responsibility to:

- set control objectives (eg, creditors' system controls should exist to ensure that valid and timely payments are made)
- establish and maintain an adequate system of internal control (eg, by division of responsibilities) for all major systems.

30. The role of internal audit is to assess the extent to which individual controls contribute to the overall control system and to advise management on setting up or changing systems of internal control.

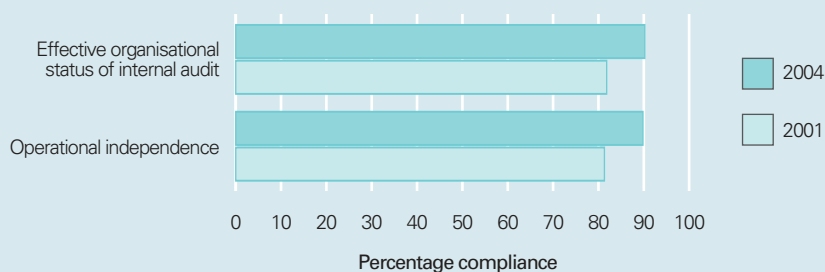
31. This remains an area of poor performance. After three years, only 12 councils 'almost fully comply' with the Code. In 20 councils, there is still scope for improvement. Audit Scotland found that:

- nineteen (2001: 16) councils did not have defined control objectives for all major systems
- in six (2001: nine) councils, internal audit was not adequately consulted about changes to internal control systems.

Exhibit 7

Maintaining internal audit independence: Performance in 2001 and 2004

Performance has improved in both areas.



Source: External auditors' returns 2001 and 2004

Recommendation

Managers should establish and maintain an adequate system of control, and define control objectives for all major systems.

Having a clear role in relation to fraud

32. It is important that the council has both a strategy for dealing with fraud and corruption and a fraud response plan setting out the procedures to be followed in the event of a suspected fraud. These procedures should be clearly communicated to all staff. Following the Public Interest Disclosure Act 1998, councils should have a whistle-blowing policy or confidential reporting procedure for staff.

33. Councils showed a marked improvement in this area. In 2001, 11 councils did not have an adequate anti-fraud and corruption strategy and ten did not have a fraud response plan. In 2004, two councils do not have a fraud response plan (Moray and Scottish Borders). In 2001, 11 councils did not have a whistle-

blowing policy communicated to all staff. In 2004, only East Lothian had not finalised a policy.

Critical success factor 2 – Maintaining internal audit independence

34. Internal audit should be seen to be independent in exercising judgement, reporting opinion and presenting recommendations. To achieve this, internal audit needs to be free of operational tasks and to have sufficient organisational status to enable it to perform its duties properly. This critical success factor is supported by two statements of good practice (Exhibit 7):

- effective organisational status of internal audit
- operational independence.

Effective organisational status of internal audit

35. Chief internal auditors must be able to report their findings in their own name without fear or favour, and their line managers should not influence their reports. Although it is for each council to decide where the

chief internal auditor fits into its management structure, the associated status must ensure that internal audit can function independently.

36. Where the chief internal auditor's line manager is lower in the structure than the director of finance (or equivalent), there is a risk that the status and independence of the chief internal auditor may be compromised.

37. In five (2001: eight) councils, the chief internal auditor does not report to the responsible finance officer or to a more senior manager in the council (Angus, East Dunbartonshire, City of Edinburgh, Falkirk and South Lanarkshire).

Operational independence

38. Internal auditors should not have operational responsibilities outside audit. This means that if internal audit was not involved, the operational process would continue unaffected.

39. Audit Scotland found that:

- four (2001: five) internal audit services were assessed to be involved in operational tasks that could compromise their independence (Clackmannanshire, Orkney Islands, Perth & Kinross and Scottish Borders).

Critical success factor 3 – Planning and controlling the work of internal audit

40. A structured framework of strategic, annual and individual project plans helps internal audit to both consult with members and senior managers, and ensure that the work programme is properly focused on the council's needs. Internal audit resources need to be prioritised to target areas of greatest risk to ensure they are used effectively.

41. Good working relationships with external auditors and inspectorates help develop an integrated approach to audit. This enables the overall burden of audit and inspection to be minimised. Internal audit needs to maintain good working papers to be able to present findings and make recommendations that can be supported by robust evidence. This critical success factor is supported by four statements of good practice (Exhibit 8):

- risk assessment
- audit planning
- working relationships
- managing, controlling and recording work.

Risk assessment

42. A structured risk assessment methodology is required to properly prioritise and plan internal audit work. It should cover both financial and operational systems and be regularly reviewed, particularly in periods of organisational change.

43. In the initial study, risk assessment was the weakest area identified, and in the follow-up it remains one of the weakest areas. Audit Scotland found that:

- there remain ten (2001: 14) councils who do not use a formal process to assess risks
- internal audit bases its risk assessment on information from the authority's risk management process and an agreed audit risk methodology in only 11 (2001: 12) councils, one fewer than in 2001
- in seven (2001: eight) councils, internal audit did not use the risk assessment to prepare audit plans and prioritise its work.

Recommendation

All councils should have in place a well-developed corporate risk assessment process.

Audit planning

44. Internal audit requires a structured planning framework of strategic, annual and project plans to ensure that all council systems are kept under review.

- The strategic plan based on the risk assessment should link to the council's corporate aims and objectives, and determine a schedule of systems to be reviewed (with the frequency of review having regard to their assessed risk). It should also identify the resources required to undertake this work.
- The annual plan should be derived from the strategic plan and detail the work to be undertaken in any year. To ensure risks are properly managed, annual plans should be sufficiently flexible and include an element of contingency to

accommodate work which could not have been reasonably overseen. This will ensure that all priority work is completed within the scheduled time.

- Operational plans should be prepared for each project in consultation with client managers and set out the scope and objectives of the work, time-scales and reporting arrangements.

45. The assessments conducted by external auditors in 2004 showed that, overall, 13 councils 'almost fully complied' with the Code. However, there remains scope for improvement in 19 councils:

- in 17 (2001: 16) councils, strategic plans did not link back to the council's corporate aims and objectives, a poorer position than in 2001
- in nine (2001: 11) councils, strategic plans were not informed by comprehensive risk assessment
- in ten (2001: 22) councils, strategic plans did not set out the resources required to meet the internal audit needs of the council
- in six (2001: ten) councils, internal audit strategic plans were not reviewed to reflect the changed priorities of the council.

Working relationships

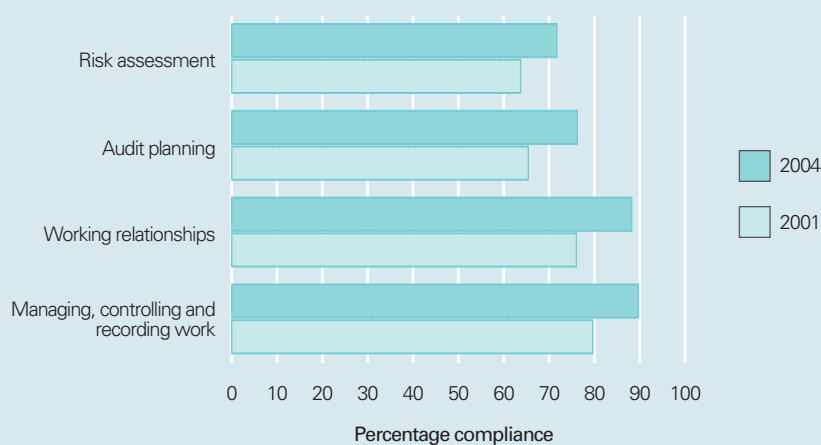
46. To undertake its work effectively, internal audit should foster constructive working relationships with management, external auditors, inspectorates, other review agencies and with the audit committee or equivalent mechanism.

47. Overall, internal audit performed well in this area. However, there is scope for improvement in the way internal audit co-ordinates its work with external audit and other

Exhibit 8

Planning and controlling the work of internal audit: Performance in 2001 and 2004

Performance in all areas has improved, but risk assessment and audit planning are still poor.



Source: External auditors' returns 2001 and 2004

review agencies. This often affects the extent to which external audit places reliance on the work of internal audit.

48. In the course of their audit, external auditors assess the extent to which they can rely on internal audit work to ensure the best use of overall resources available for audit. For the financial year 2002/03, external auditors reported that:

- full reliance could be placed on the work of internal audit in 16 councils
- partial reliance could be placed on the work of internal audit in 15 councils
- no reliance could be placed on the work of internal audit in one council (East Dunbartonshire).

49. Councils who 'almost fully complied' with the Code tended to be the councils where external auditors could place full reliance on the work of internal audit. Likewise, the relatively poorer-performing councils tended to be the councils

where external auditors could only place partial or no reliance on the work of internal audit. However, a small number of councils performed well overall, but external auditors only placed partial reliance on the work of their internal audit sections. In these councils, more reliance would have been possible if, for example, satisfactory line management arrangements had been in place or adequate resources were available.

Managing, controlling and recording work

50. Sound management of the internal audit section and of individual assignments ensures that internal audit objectives are achieved and work is performed effectively. The chief internal auditor must establish suitable arrangements for managing internal audit work. Although, in general, internal audit performed well in this area, there is still room for improvement in some councils. The study found that:

- internal audit sections in two (2001: eight) councils do not have documented policies and procedures contained in an

audit manual (Midlothian and Orkney Islands)

- in one (2001: five) council, (East Dunbartonshire), internal audit work is not adequately documented at all levels, from audit planning to reporting.

Critical success factor 4 – Resourcing the internal audit work programme

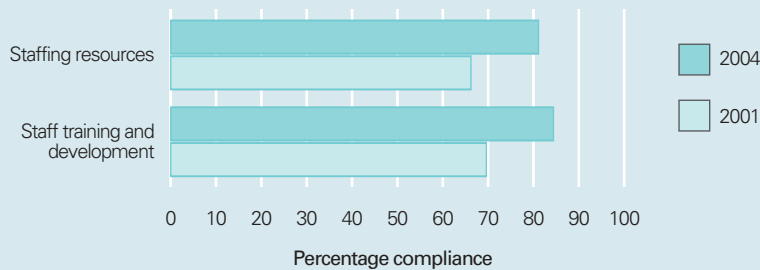
51. Internal audit services need to be properly resourced to complete their agreed work programme efficiently, effectively and on time. Internal audit work requires a balance of skills, experience and qualifications. Staff should be supported with needs-based training to enable them to develop the skills required to meet both current and future work challenges. This critical success factor is supported by two statements of good practice ([Exhibit 9 overleaf](#)):

- staffing resources
- staff training and development.

Exhibit 9

Resourcing the internal audit work programme: Performance in 2001 and 2004

Performance has improved, but there is still scope for further improvement, in the area of staffing resources in particular.



Source: External auditors' returns 2001 and 2004

Staffing resources

52. Internal audit needs to have the appropriate number and quality of staff to do the required work and manage these resources efficiently and effectively. It is for each council to decide the level of internal audit resources required to meet its internal control needs based on a comprehensive assessment of the risks facing the council.

53. In 24 councils, the internal audit service was resourced fully by in-house staff. In the remaining eight councils, some services were outsourced. In four of these, this related mainly to the provision of computer auditing. In the other four councils (Argyll & Bute, Eilean Siar, Inverclyde and Renfrewshire), partnership arrangements with the private sector have been put in place. These councils are all now in the top performance band, and two, Argyll & Bute and Inverclyde, have moved from the bottom to the top performance band. No Scottish councils have entered into consortia arrangements ie, a group of councils agreeing to set up an internal audit team jointly between them.

54. The total amount invested in internal audit in all 32 Scottish councils is £9.8 million – about 0.1% of aggregate council expenditure. Staffing levels have remained broadly static since the initial report was published in 2001. There are 292 (2001: 300) full-time equivalent (FTE) established posts of which 272 (2001: 265) were filled at the date of the study.

55. The size of internal audit services varies significantly between councils, ranging from 2 FTE in Orkney Islands to 23.5 FTE in Fife. Economies of scale may apply in the larger councils, but there is wide variation in the number of internal audit staff employed by broadly comparable councils.

56. The initial report identified that a richer skill mix was most commonly found in better-performing councils. A higher proportion of internal audit staff (55% in comparison with 45%) now hold a professional accountancy qualification.

57. Exhibit 10 shows a comparison of the qualifications held by internal audit staff across Scotland between

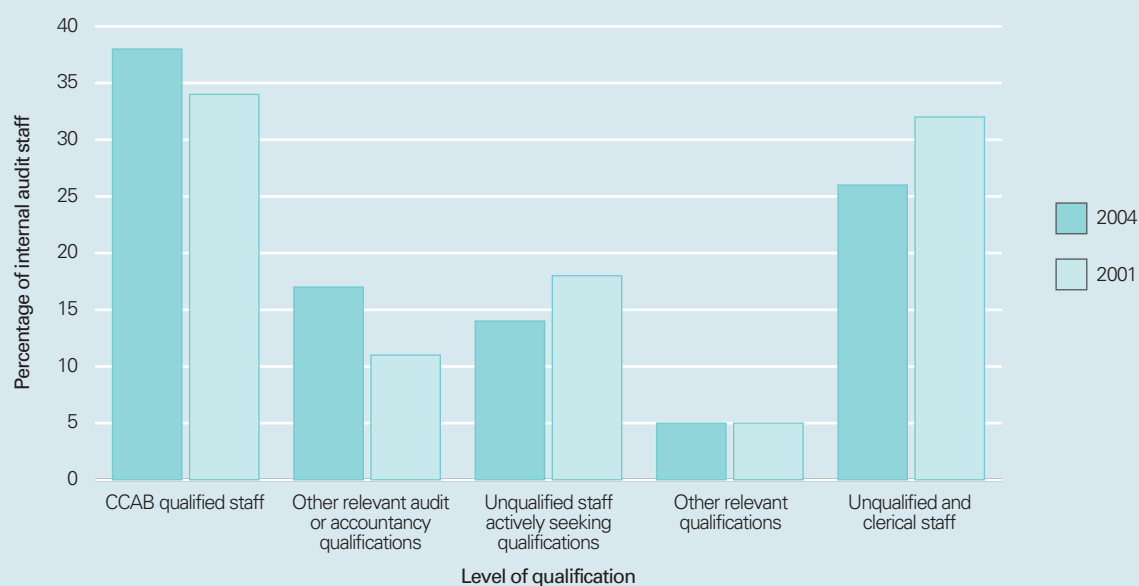
2001 and 2004. The proportion of internal audit staff holding a CCAB (Consultative Committee of Accountancy Bodies) qualification has risen, as has the proportion of internal audit staff with other relevant audit or accountancy qualifications, such as membership of the IIA (Institute of Internal Auditors) or those who hold an AAT (Association of Accounting Technicians) qualification. A slightly lower proportion of unqualified staff are pursuing accountancy qualifications, and the proportion of unqualified and clerical staff working within internal audit has fallen.

58. External auditors judged that ten (2001: 12) internal audit services did not have adequate resources to enable them to meet their work objectives efficiently and effectively. They also found that recruitment of internal audit staff remains a problem for many councils. At the time of the follow-up study, there were 20 (2001: 35) vacant internal audit posts across Scottish councils, representing 7% (2001: 12%) of internal audit's overall establishment.

Exhibit 10

Qualifications amongst internal audit staff

In 2004, a higher proportion of staff have a professional accountancy qualification than in 2001.



Source: External auditors' returns 2001 and 2004

Recommendation

Councils should conduct an option appraisal for procuring internal audit services to establish whether:

- the council's internal audit needs are being met
- internal audit has the relevant skills and experience to meet the current and changing needs of the organisation
- the service could be improved by entering into consortia arrangements with other councils, partnership arrangements with the private sector, or by contracting all, or elements of the service to the private sector.

Staff training and development

59. Training should be tailored to the needs of individual auditors to help them meet their current responsibilities and the challenges they are likely to face, for example, the need for improved IT skills.

60. This is an area where internal audit performs well overall. However, in two (2001: ten) councils (Falkirk and Midlothian), the chief internal auditors do not formally co-ordinate and review the training and development requirements of staff. In four (2001: 13) councils, there was no specific internal audit induction training for new staff (Falkirk, Midlothian, North Lanarkshire and West Dunbartonshire), and in four (2001: nine) councils, training was not tailored to the needs of individual auditors, covering both theoretical knowledge and its application (East Dunbartonshire, Falkirk, Moray and South Ayrshire).

Critical success factor 5 – Reporting and follow-up arrangements

61. It is internal audit's responsibility to submit timely reports to management identifying the findings from its work and making recommendations for improvement.

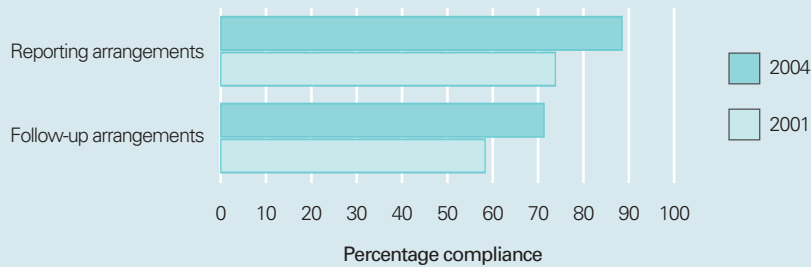
62. Systematic follow-up procedures ensure that management has implemented internal audit recommendations within agreed time-scales or has understood and assumed the risk resulting from not taking action. This critical success factor is supported by two statements of good practice ([Exhibit 11 overleaf](#)):

- reporting arrangements
- follow-up arrangements.

Exhibit 11

Reporting and follow-up arrangements: Performance in 2001 and 2004

Although performance has improved, follow-up arrangements remain a weak area.



Source: External auditors' returns 2001 and 2004

Reporting arrangements

63. Audit Scotland found that:

- despite the introduction of the statement on the system of internal financial control, in six (2001: 22) councils (East Lothian, Midlothian, Moray, Orkney Islands, Perth & Kinross and West Dunbartonshire), the chief internal auditor did not produce an adequate annual report containing a view on the soundness of the council's internal control system
- in four (2001: 12) councils, reporting arrangements, including time-scales for drafting, completion and management action, had not been agreed with management (Dumfries & Galloway, Moray, Orkney Islands and Perth & Kinross)
- in three (2001: seven) councils, the internal audit service did not have documented, systematic procedures in place for producing and clearing reports (Midlothian, Moray and Orkney Islands).

Follow-up arrangements

64. It is the responsibility of management to implement agreed recommendations or accept the risk resulting from not taking action. Internal audit should have systematic follow-up procedures in place to monitor the implementation of its recommendations. The results of the follow-up work should be used by internal audit to update its risk assessment and plan its future work. Low priority given to follow-up work is counter-productive in the long term, as the effect of implementation of recommendations cannot be assured. This can undermine the whole audit process.

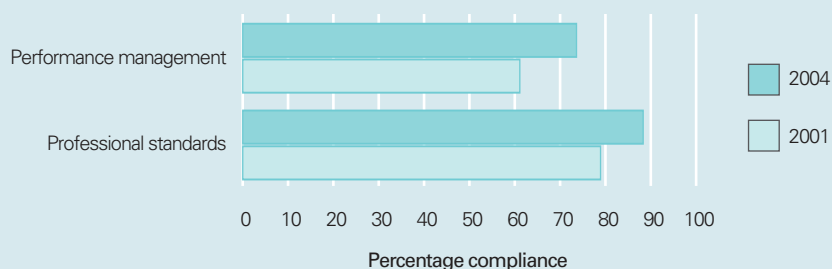
65. Only nine councils 'almost fully comply' with the Code, whilst improvement is still required in 23 councils. Audit Scotland found this to be the weakest area in the follow-up study:

- 22 (2001: 18) internal audit services did not use the results of follow-up work to update their risk assessment, a poorer position than in 2001
- six (2001: 14) did not report to the corporate management team instances where service managers failed to implement remedial action plans
- six (2001: ten) did not use the results of follow-up work to update their audit plans.

Exhibit 12

Holding internal audit to account: Performance in 2001 and 2004

Performance management remains a relatively weak area.



Source: External auditors' returns 2001 and 2004

Critical success factor 6 – Holding internal audit to account for its performance

66. The effectiveness of internal audit is enhanced if it operates within a performance management framework that embraces professional standards, performance review and continuous improvement. Where effective performance review processes are not in place, there is a risk that the council may not be getting appropriate assurance on the level of internal controls in operation. This critical success factor is supported by two statements of good practice (Exhibit 12):

- performance management
- professional standards.

Performance management and professional standards

67. The chief internal auditor should promote and maintain quality standards within the internal audit section. Performance measures and indicators can be used to demonstrate whether internal audit is achieving its planned objectives and delivering Best Value. There was scope for 11 (2001: 9) chief internal auditors to further develop their use of performance indicators to measure the performance of their service. Independent accreditation can assist in ensuring that appropriate standards are in place. Ten (2001: 12) councils have such accreditation.

68. External auditors rated the standards of professional and ethical behaviour of internal audit staff as high across all councils.

Part 3. Implementing new responsibilities



69. Since the initial study in 2001, a number of developments have affected councils' arrangements for internal audit and the skills required by internal auditors to provide an effective audit service. From 2002/03, the Accounting Code of Practice (ACOP) required local authorities to include, within their accounts, a statement on their system of internal financial control (SSIFC). Internal audit services have a key role to play in producing evidence to support this statement. In addition, there is an increasing expectation on councils to have effective audit committee arrangements in place.

70. A new CIPFA Code for Internal Audit in Local Government was published in September 2003 which takes account of these developments. Questions covering the changes made in the 2003 Code, mainly in relation to audit committees and internal financial control statements, were added to the initial methodology. This enabled Audit Scotland to assess the degree of change required in Scottish councils to meet the obligations of the new Code.

71. This section summarises Audit Scotland's key findings and identifies actions that councils need to take to ensure that their internal audit services are prepared to meet the new challenges facing them.

Audit committees

72. The effectiveness of internal audit is enhanced by a properly functioning audit committee. An audit committee should hold internal audit to account by monitoring progress against plans, outputs and performance. All local authorities should be able to demonstrate that they are complying with audit committee principles in order to meet the requirements of good corporate governance. Audit committee principles are intended to provide assurance to all the stakeholders of the authority, both internal and external.

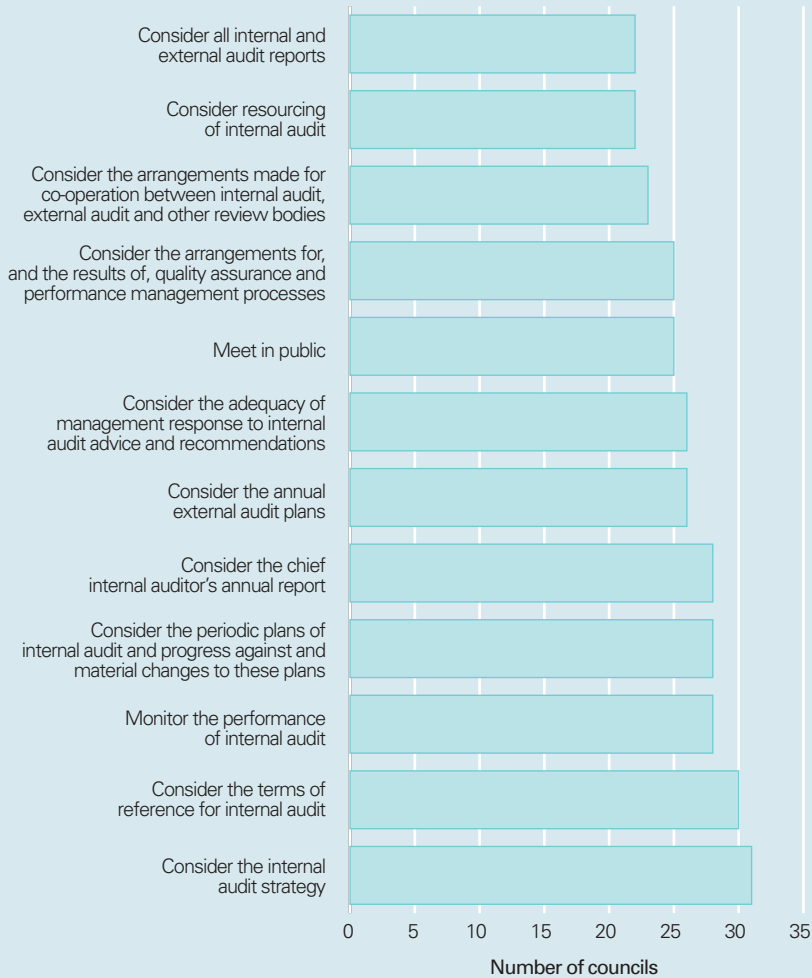
73. External auditors found that although all councils indicated that they had established an audit committee or equivalent, a third did not operate fully under audit committee principles ([Exhibit 13](#)):

- a fifth do not consider the adequacy of management response to internal audit advice and recommendation
- a third do not consider the resourcing of internal audit or consider all internal and external audit reports
- nearly a quarter do not meet in public.

Exhibit 13

Extent to which audit committees in Scottish councils are operating fully under audit committee principles

A fifth of audit committees do not consider the adequacy of management response to internal audit advice and recommendations.



Source: External auditors' returns 2004

74. The Accounts Commission regards the adoption and implementation of audit committee principles as an important step in raising the standards of corporate governance in local government.

75. Whilst acknowledging that all councils have taken steps to implement audit committee principles, the Commission has already expressed concern at the effectiveness of the arrangements in place in some councils, commenting that *... still only a third of Scottish councils have fully established such a committee... they have proved to be a powerful tool of audit and scrutiny in those councils where they exist. We are further concerned that where Audit or Scrutiny Committees have been established, it is sometimes not clear that they have the independent status and membership necessary to contribute meaningfully to the development of good governance. We believe that Audit Committees are a vital part of modern governance in public bodies and that they reinforce democratic accountability.*¹

76. In June 2004, the CIPFA in Scotland Directors of Finance Section published a guidance note on audit committee principles in local authorities in Scotland. The guidance is a practical tool to aid all those with an interest in, or responsibility for, audit committee principles, and describes clear features of good practice. It should assist councils to improve arrangements for audit committees.

Recommendation

All councils should have audit committees which operate fully under audit committee principles.²

Internal financial control statements

77. From 2002/03, the Accounting Code of Practice (ACOP) required local authorities to include, within their accounts, a statement setting out the framework within which financial control is managed and reviewed and the main components of the system, including the arrangements for internal audit. This is called the statement on the system of internal financial control (SSIFC) and is intended to provide assurance to stakeholders.

78. The requirement to have the responsible finance officer of the council and/or the chief executive certify the adequacy of internal financial controls provides a focus on management's need to establish effective arrangements for internal control and internal audit. Internal audit has an important role to play in providing information and evidence to management relevant to the preparation of the SSIFC.

79. In assessing internal audit sections in Scottish councils' preparedness for the SSIFC, external auditors found that:

- in four councils, the chief internal auditor did not provide timely information to those charged with governance to use in the preparation of the SSIFC
- in a quarter of councils, the chief internal auditor's annual report did not draw attention to issues judged to be particularly relevant to the preparation of the SSIFC
- half of councils did not clearly state in their internal audit strategy how they were going to provide assurance for the SSIFC.

¹ *Overview of the 2002/03 local authority audits*, Accounts Commission findings, April 2004.

² As set out in *Audit Committee Principles in Local Authorities in Scotland: A guidance note*, CIPFA in Scotland Directors of Finance Section, June 2004.

Part 4. Conclusions and recommendations

Conclusions

80. All councils need sound internal control systems and strong corporate governance arrangements. An effective internal audit service can be a major contributor to achieving this. This follow-up study has found that nearly all councils have improved their performance but, after three years, some still have a lot to do in raising their standards to those reflected in the Code.

81. There are specific areas where many Scottish councils still need to improve:

- risk assessment and management – a well-developed risk assessment process is required at corporate level and for internal audit
- strategic planning – strategic plans should be linked back to the council's corporate aims and objectives, be based on risk assessment and should set out the resources required to meet the audit needs of the council

- follow-up of recommendations – instances where service managers fail to implement remedial action plans should be reported to the corporate management team and the results of follow-up work should be used to update the risk assessment and, subsequently, the internal audit section's audit plan.

82. In addition, many councils should improve their arrangements for:

- audit committees – to meet the requirements of good corporate governance, all councils need to have in place audit committees which operate fully under audit committee principles
- internal audit's input regarding the preparation of the statement on the system of internal financial control – the chief internal auditor must provide management with timely information to use in the preparation of the SSIFC, and should clearly state how assurance will be provided in internal audit's strategic plan.

83. All councils should follow the 2003 CIPFA Code of Practice for Internal Audit in Local Government. In particular, they should address the recommendations listed at the end of the report. Councils will have received individual reports from their external auditor assessing their level of compliance with the Code in early 2004. Each council is expected to take action to address the issues contained in their external auditor's report. Responsibility for addressing these issues lies, ultimately, with the political leadership in the council as well as with the chief internal auditor. It also requires the support of the chief executive, director of finance and heads of services.

Recommendations

1. All councils should review their performance against the 2003 CIPFA Code of Practice for Internal Audit in Local Government and take action to ensure they are complying fully with the Code.
2. Managers should establish and maintain an adequate system of control and define control objectives for all major systems.
3. All councils should have in place a well-developed corporate risk assessment process.
4. Councils should conduct an option appraisal for procuring internal audit services to establish whether:
 - the council's internal audit needs are being met
 - internal audit has the relevant skills and experience to meet the current and changing needs of the organisation
 - the service could be improved by entering into: consortia arrangements with other councils; partnership arrangements with the private sector; or by contracting all, or elements of the service to the private sector.
5. All councils should have audit committees which operate fully under audit committee principles.³

Appendix 1: Assessment and scoring methodology

Undertaking the assessment

External auditors assessed each council's arrangements for internal audit against accepted good practice as set out in the CIPFA Code of Practice for Internal Audit in Local Government. The assessments for the follow-up study were completed during early 2004 and reflect councils' arrangements as at 1 March 2004, while the assessments for the initial study were completed in February 2001.

The performance assessment framework used by external auditors is based on six critical success factors. Auditors scored council performance by testing almost 100 processes and outcomes within 15 areas of good practice ([Exhibit 14 overleaf](#)). These reflect the issues that the study advisory group for the initial study and other consultees (including council internal auditors and the Commission's appointed external auditors) felt were essential for delivering an effective internal audit service.

External auditors tested documentary evidence, processes and outcomes to assess the degree of compliance with good practice. The following example shows how the scoring system was applied to documentary evidence:

- 1 = 'no' – performance does not comply with good practice (eg, document does not exist or very early draft)
- 2 = 'qualified no' – performance, on the whole, does not comply with good practice (eg, terms of reference are available in draft but have yet to be approved and are not in use operationally, or a formally approved document which misses out most of the important issues)

- 3 = 'qualified yes' – performance, on the whole, complies with good practice (eg, formally approved document which misses some important issues, or a draft document that, although yet to be formally approved, is in use operationally)
- 4 = 'yes' – performance complies with good practice (eg, formally approved document covering all of the important issues).

Consistency and validation checks

To ensure auditors' assessments were consistently scored, the study team provided training and undertook robust validation procedures, including:

- training workshops for auditors to familiarise them with the methodology and assessment process
- further workshops to ensure that auditors' assessments were undertaken consistently
- consistency checks on auditors' assessments and council data returns
- a sample of 40% of assessments subjected to independent peer review by other external auditors.

Although the study team has made every effort to ensure that the assessments have been scored on a consistent basis, there always remains a small element of subjectivity in scoring performance.

Assessing overall performance

The scores for each test were used to calculate the average score for each statement. These were then used to calculate a council score for each of the six critical success factors.

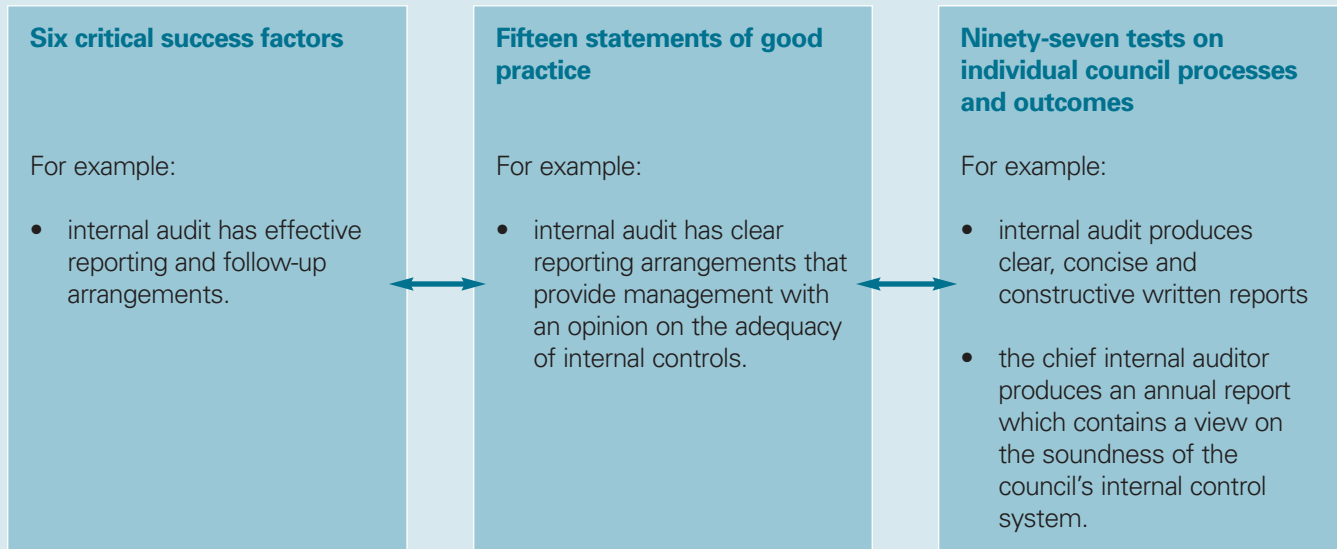
In the initial study, scores for the six critical factors and the 15 statements for each council were used to create bands of performance. [Exhibit 15 \(overleaf\)](#) shows the link between council scores and performance bands. These same ranges were used in the follow-up study to place councils in performance bands.

[Exhibit 16 \(overleaf\)](#) shows how the average scores convert to 'hotel star' ratings ([Appendix 2 page 28](#)). The star ratings indicate each council's performance for each statement. Because these have been rounded, adding them together may not produce the council's overall score.

Exhibit 14

Structure of the assessment

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



Source: Audit Scotland

Exhibit 15

The link between council scores and performance bands

Councils' actual scores from the initial study were used to assess overall compliance and to create performance bands.

Overall compliance with the Code ⁴	Performance bands created from analysis of actual results – initial study	
	Percentage	Performance band
83 – 100	1	3.50 - 4.00
70 – 83	2	3.10 - 3.50
50 – 70	3	2.50 - 3.10
25 – 50	4	1.75 - 2.50
0 – 25	5	1.00 - 1.75

Source: Audit Scotland

⁴ The percentage compliance was calculated for each score in the following manner – 'Percentage compliance = (score – 1) / 3 x 100'. Because the lowest score that a council could achieve is 1 and the highest is a 4, a score of 2.5 represents a percentage compliance score of 50%.

Exhibit 16

The relationship between 'hotel stars' and average scores

The 'hotel stars' reflect the performance bands.

Average scores for each statement		Hotel stars symbol
Equal to or more than	But less than	
3.50	4.00	★★★★★
3.10	3.50	★★★★
2.50	3.10	★★★
1.75	2.50	★★
1.00	1.75	★

Source: Audit Scotland

The colour of the 'hotel stars' indicates whether, in 2004, performance has improved (green), remained the same (black), or deteriorated (red) in comparison with 2001. Within bands, councils are listed in alphabetical order, not in order of performance.

		Internal audit properly manages, controls and records its work	Internal audit is adequately staffed and resourced	Internal audit staff are suitably trained and developed	Internal audit has clear reporting arrangements that provide management with an opinion on the adequacy of internal controls	Internal audit follows up its recommendations to ensure action is taken	Internal audit has a performance management framework that ensures continuous review of its performance	The chief internal auditor promotes and maintains professional standards in internal audit
Band	Council	9	10	11	12	13	14	15
1	Aberdeenshire	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	Angus	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	Argyll & Bute	★★★★★	★★★★★	★★★★	★★★★★	★★★★★	★★★★	★★★★★
	Dundee City	★★★★★	★★★★	★★★★★	★★★★★	★★	★★★★	★★★★★
	East Ayrshire	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	East Renfrewshire	★★★★★	★★★★★	★★★★★	★★★★★	★★★	★★★★	★★★★★
	Edinburgh, City of	★★★★★	★★★★★	★★★★★	★★★★★	★★★	★★★★★	★★★★★
	Eilean Siar	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★
	Glasgow City	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★	★★★★★
	Highland	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	Inverclyde	★★★★★	★★★★	★★★★	★★★★★	★★★★★	★★★★★	★★★
	North Lanarkshire	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★	★★★★★
	Renfrewshire	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	Shetland Islands	★★★★★	★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	South Lanarkshire	★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
	Stirling	★★★★★	★★★★	★★★★★	★★★★★	★★★	★★★	★★★★★
	West Lothian	★★★★★	★★★★★	★★★★★	★★★★★	★★★	★★★★★	★★★★★
2	Aberdeen City	★★★★★	★★★	★★★★	★★★★★	★★★★	★★★★★	★★★
	Clackmannanshire	★★★★★	★★★★	★★★	★★★★★	★★★	★★★	★★★★★
	Dumfries & Galloway	★★★★★	★★★★★	★★★★★	★★★★★	★	★★★	★★★★★
	East Lothian	★★★★★	★★★	★★★★	★★★	★★★★	★★★	★★★
	Fife	★★★★★	★★★★★	★★★★★	★★★★★	★★★	★★★★★	★★★★★
	Moray	★★★★★	★★★★	★★★	★★★	★★★	★★★	★★★★★
	North Ayrshire	★★★★	★★★	★★★★	★★★★★	★★★	★★★	★★★★★
	Perth & Kinross	★★★	★★★★	★★★★★	★★★	★★★★	★★★	★★★★★
	Scottish Borders	★★★	★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★★
	South Ayrshire	★★★★★	★★★★	★★★	★★★★★	★★★	★★★	★★★★★
	West Dunbartonshire	★★★★	★★★★★	★★★	★★★★	★★	★★★	★★★★★
3	East Dunbartonshire	★★★	★★★★	★★★	★★★★★	★★★	★★★	★★★★
	Falkirk	★★★★	★★★	★★	★★★★	★★★	★★★	★★★
	Midlothian	★★★	★★★	★★	★★★	★★★	★★	★★★★★
	Orkney Islands	★★★★★	★★	★★★★	★★★	★★★★	★★★	★★★★★
	Scotland	★★★★★	★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★★

Number of councils by assessment band for each statement

Band	Assessment	Number of councils by assessment band						
1	★★★★★	24	16	19	25	9	14	27
2	★★★★	6	11	6	3	9	5	1
3	★★★	2	4	5	4	11	12	4
4	★★	0	1	2	0	2	1	0
5	★	0	0	0	0	1	0	0
	Total no. of councils	32	32	32	32	32	32	32

A job worth doing

Raising the standard of internal audit in Scottish councils

A follow-up report



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