



Audit Committee

27 June 2008

Agenda Item 12c

Manchester City Council

Audit 2007/08

Review of internal audit arrangements

16 June 2008

Review of internal audit arrangements

Background

- 1.1 In our Audit and Inspection Plan 2007/08, we identified internal control and governance arrangements as an area requiring audit work during the year to support our conclusion on the adequacy of the Council's arrangements for ensuring value for money in the use of its resources. One of the strands of this work is a review of the internal audit function. Annual review of internal audit arrangements and work on critical financial systems is also required to support our accounts opinion.
- 1.2 Our external audit plans are agreed on the assumption that the Council has a robust internal control environment. A key source of assurance to support this assumption is the work of internal audit. In order that we can place reliance on internal audit's work we carry out an annual assessment of internal audit, including compliance with the CIPFA Code of Practice for Internal Audit (Code of Practice). We do this by performing a full assessment every three years, with annual updates in between.
- 1.3 Robust arrangements for internal audit are an essential component of good governance and internal control and are a key element of the use of resources assessment of the Council under the 2008 Comprehensive Performance Assessment (CPA) and, from 2009, the Comprehensive Area Assessment (CAA).
- 1.4 In January 2008, the Audit Commission finalised the report arising from its detailed 2006/07 review of internal audit. At the time of the Audit Commission's work (June 2007), internal audit was assessed as generally complying with the Code of Practice. However, a number of recommendations for improvement were made, the most significant relating to staffing levels, including senior level vacancies and the number of relatively inexperienced staff. Internal audit reported to the January Audit Committee that a number of planned 2007/08 reviews would have to be deferred due to this shortfall in staffing.
- 1.5 Internal audit is currently undergoing a Service Improvement Programme (SIP) review to look at its structure and operation.

Scope of audit work

- 1.6 We have carried out a review of the Council's internal audit arrangements, as part of our work in assessing the Council's internal control and governance arrangements. We have also reviewed a sample of internal audit jobs to determine if we can place specific assurances over the effective design and operation of controls within financial systems, to support our accounts opinion work.

- 1.7 Our work was structured to help the Council improve its internal audit arrangements and was carried out with reference to our associated work on risk management, the audit committee and the Annual Governance Statement (AGS) arrangements.
- 1.8 Our work was also carried out with reference to the ongoing internal audit SIP review.

Methodology

- 1.9 Our work was carried out to obtain assurance that internal audit arrangements and work comply with the Code of Practice and can be relied upon to support our accounts opinion and use of resources conclusion.
- 1.10 We did this by reviewing and updating last year's review by the Audit Commission, through meetings with the Audit Commission and Head of Internal Audit, and review of key documentation. We also reviewed a selection of completed 2007/08 internal audit jobs.
- 1.11 Drawing on wider public sector and commercial expertise from our Business Risk Services team, we met with the Head of Internal Audit to discuss and provide constructive challenge on implementation plans to address the improvement areas identified from the Audit Commission review and matters arising from our assessment.
- 1.12 To facilitate the Council in addressing the matters that we have raised, we have reported on an exception basis and have not included reference to areas of the Code of Practice where Internal Audit is fully compliant.

Key findings

- 1.13 Our overall assessment is that internal audit does not fully comply with the Code of Practice. There are three key issues underlying our assessment:
- **The role and expectations of internal audit are unclear within the Council**, in part because the Council does not yet have formal integrated processes for governance. This means that internal audit lacks strategic direction and works to a plan that is constantly changing, balancing substantial management requests for work against planned work required to provide assurances for the AGS
 - **The Council is unable to recruit and retain adequate internal audit resource** of the right qualifications and experience to manage and deliver its work programme. Since the Audit Commission's review was performed, in June 2007, internal audit staffing levels have reduced, particularly at a senior level. Limited benchmarking of internal audit salaries, exit interviews and responses to recent Council job adverts suggest that the Council's internal audit salaries may not be competitive. The continued operation of an interim internal audit structure and absence of strategic direction for internal audit may be further barriers to recruitment.

- **The internal audit SIP is not yet complete and there is insufficient senior internal audit resource to complete it by June 2008.** The SIP was intended to be the process by which internal audit would identify its preferred structure and mode of operation. As such, significant developments in internal audit, such as establishing and recruiting to a permanent structure, have been on hold, pending completion of the SIP. However, progress in carrying out the SIP has been slow, due to difficulties in resourcing the work from internal audit. We are not aware of any alternative proposals to ensure that the SIP is delivered by June 2008.

1.14 These issues have resulted in our assessment that internal audit does not fully comply with the Code of Practice, as shown in the table below.

Code area	Compliant?	Reasons for non-compliance
Scope of Internal Audit	✓	-
Independence	✓	-
Ethics	✓	-
Audit Committees	✓	-
Relationships	✓	-
Staffing, Training and Continuing Professional Development	✗	<p>There is insufficient audit resource to deliver the audit plan, ad hoc audit work and the SIP.</p> <p>Internal audit continues to have an interim structure.</p> <p>There is a high proportion of unqualified or inexperienced staff.</p> <p>The overall resource position is deteriorating.</p>

Code of Practice area	Compliant?	Reasons for non-compliance
Audit Strategy and Planning	×	<p>The 2007-08 plan was based on an unrealistic assumption of full staffing.</p> <p>The audit plan presented to members does not fully demonstrate that it addresses the Council's key risks or the contribution that audit work will make towards the overall assurances required. The plan is also not sufficiently clear in stating the objectives of each aspect of work and the quantum of work required.</p> <p>Internal audit performs significant unplanned work.</p> <p>Internal audit has not yet been able to quantify the extent of under delivery of the 2007/08 plan.</p>
Undertaking Audit Work	✓	-
Due Professional Care	✓	-
Reporting	×	<p>Insufficient clarity of reporting of progress against the audit plan to Audit Committee.</p> <p>Unclear articulation of the extent of non-delivery of the internal audit plan, the reasons for this, the impact on planned assurance, suggestions for remedial action and what the Audit Committee may do to help.</p>
Performance, Quality and Effectiveness	✓	-

- 1.15 Due to less than expected internal audit coverage of core financial systems, we have been unable to obtain the expected assurances over the effective design and operation of controls within financial systems, to support our accounts opinion work. This may result in increased external audit work and fee. We will confirm the extent of this following issue of our accounts opinion.

Recommendations

- 1.16 Our recommendations, which have been agreed with management, are summarised at Appendix 1. The highest priority actions are for the Council to formally clarify the role and function of internal audit, within an integrated framework of governance, and finalise and staff up to an agreed structure.

Next steps

- 1.17 We will present our report to Audit Committee in June 2008 and will update our assessment prior to forming our use of resources conclusion in September 2008.

Grant Thornton UK LLP
16 June 2008

Appendix 1 – Key findings and action plan

Findings by Code of Practice area	Recommendations	Management response	Implementation details
<p>The scope of internal audit</p>			
<p>There is a lack of clarity of the role and function of internal audit, which contributes to the ad hoc nature of the work programme and hinders implementation of required improvements.</p>	<p>1. The Council should formally clarify the role and function of internal audit within an integrated framework of governance.</p>	<p>1. Agreed. Work has already commenced and will be informed by the evidence of approaches in other authorities and by the views of CMG and SMT. Once the role and function has been agreed, the size and structure of Internal Audit needed to deliver it can be determined.</p>	<p>Scoping report for CMG/SMT' commissioned by Chief Executive/City Treasurer from Assistant Chief Executive (Performance) – completion by end of June 2008.</p> <p>Decision made in consultation with Audit Committee and implemented by City Treasurer by September 2008.</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
Independence			
<p>Internal Audit reports are approved by, and presented to the Audit Committee in the name of, the City Treasurer.</p>	<p>2. The Council should consider whether internal audit should report in its own name to Audit Committee, to better demonstrate independence.</p>	<p>2. Not agreed. The City Treasurer is responsible for the Internal Audit function and, in common with many other authorities, it is Council practice for reports to be submitted in the Chief Officer's name. This convention does not reflect on the independence or otherwise of Internal Audit.</p>	<p>Not applicable.</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
<p>Staffing, training and continuing professional development</p>			
<p>Internal audit is under-resourced (particularly at management and qualified level), and continues to operate under an interim structure. In some cases, staff have been acting-up into more senior posts for over a year.</p>	<p>3. The Council should determine and secure the level of internal audit resource needed to deliver the required annual assurances.</p> <p>4. The Council should consider further use of alternative resourcing options for internal audit, such as secondments and additional external support.</p>	<p>3. Agreed. The size and level of resource will derive from the work in response to recommendation 1 above. Recruitment plans will be informed by appropriate consideration of recruitment and retention issues in relation to audit staff.</p> <p>4. In the immediate term a recruitment exercise has been initiated to fill key vacancies and the need and scope for other internal and external sources of resourcing will be kept under review.</p>	<p>City Treasurer - October 2008</p> <p>Head of Internal Audit: Initiate recruitment - June 2008 Staff in post - October 2008</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
Audit strategy and planning			
<p>The 2007-08 internal audit plan was based on the assumption that internal audit would be fully staffed during the year, despite the Council being aware that internal audit had several vacant posts and was having difficulty recruiting.</p> <p>The internal audit plan does not fully demonstrate that it addresses the Council's key risks or the contribution that audit work will make towards the overall assurances required. The plan is not sufficiently clear in stating what it sets out to achieve in each aspect of work (e.g. assurances for the Annual Governance Statement, management support work, investigations, work to support the accounts audit) and the quantum of work required.</p> <p>Internal audit performs significant unplanned work. The annual internal audit programme is constantly changing, to deal with staffing changes, revisions to planned jobs and emerging management request work. Whilst this is common to all internal audit departments, the extent of change (coupled with the lack of strategic direction for internal audit and underdeveloped governance framework) makes it difficult to formally prioritise work, ensure focus on the areas that matter most to the Council and report the detail of changes to planned work to the Audit Committee.</p>	<p>5. Internal audit should plan to carry out only the work that it can realistically resource. If risks are identified where work cannot be resourced by internal audit, the Council needs to identify alternative arrangements for the provision of the necessary assurances over the control of those risks.</p> <p>6. Internal audit plans should clearly set out and quantify the work that will be carried out to contribute towards the framework of assurances required by the Council, as well as the purpose, scope and extent of any other work.</p>	<p>5. Agreed. Alternative sources of resource or alternative forms of delivering assurance will also be identified to bridge any resource gaps.</p> <p>6. Agreed. The 2008/09 plan will cover all areas where, on a risk based assessment, assurance work is required and also any other work that is required of Internal Audit (in future as per the outcome of the review of role and functions). The resource input will be quantified for each element of the plan and matched in total against available Internal Audit resources. The plan will be prioritised to minimise the impact of any resource shortfall.</p>	<p>Head of Internal Audit/Head of Financial Management – July 2008 and ongoing</p> <p>Head of Internal Audit – June 2008</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
<p>These factors have resulted in a substantial number of audit jobs planned for 2007/08 not being delivered in year. Internal audit has not yet been able to quantify the extent of under delivery. Non-delivery of internal audit work may compromise the internal control environment and expose the Council to unnecessary risk of loss or error.</p>	<p>7. Internal audit should improve its management information to enable better tracking and quantification of delivery of the plan, the reasons for reprioritisation of work and the reasons for any expected under-delivery.</p>	<p>7. Agreed. The need to demonstrate regularly what progress is being made against the plan, the impact of changes in levels of resource and of changes in priorities (both of which are inevitable) is accepted. The impacts will be informed by the plan prioritisation proposed in recommendation 6 above.</p>	<p>Head of Internal Audit to prepare quarterly monitoring reports from the end of the final quarter of the 2008/09 audit year (ie: in September 2008).</p>
<p>A significant issue is slippage in delivering the internal audit SIP. There needs to be a revised plan of how it will be delivered and resourced, including consideration of resource that is independent of internal audit.</p>	<p>8. The Council should consider the future role and focus of the SIP, set clear outcomes and a revised timetable for delivery, in the context of the Council's wider review of integrated governance.</p>	<p>8. Agreed. Benchmarking had already identified differing approaches across comparator authorities and the SIP Board had determined to seek the views of SMT on the future role and functions it wants Internal Audit to provide</p>	<p>Head of Financial Management/SIP Project Board in light of Assistant Chief Executive's report on future role and functions of Internal Audit.</p> <p>Report on SIP outcomes scheduled for June Audit Committee.</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
Undertaking audit work			
<p>Our review of a sample of internal audit files found that generally work is compliant with the Code of Practice.</p> <p>There is some scope for standardising the structure of files, and improving the standard of systems documentation and description of walkthrough testing.</p> <p>There was clear evidence on file of planning meetings to determine key risks for specific jobs, and reference to CIPFA key controls would help to standardise this process.</p> <p>Our meetings with a sample of departments suggest that internal audit input is valued by departments in helping to support improvement.</p>	<p>9. The internal audit quality manual, when produced, should include procedures to:</p> <ul style="list-style-type: none"> • standardise the electronic and paper file structure • ensure that each file contains systems documentation and description of walkthrough testing • incorporate CIPFA key controls into job planning. 	<p>9. Agreed. Manual will reflect the existing standardised electronic working paper system, need to ensure compliance with evidence of walkthrough testing and reference to CIPFA key controls.</p>	<p>Head of Internal Audit - October 2008</p>
Principles of reporting			
<p>Reports to the Audit Committee during 2007/08 did not clearly articulate the extent of non-delivery of the internal audit plan, the reasons for this, the impact on planned assurance, suggestions for remedial action and what the Audit Committee may do to help.</p>	<p>10. Internal audit should clearly articulate the extent of non-delivery of the audit plan.</p>	<p>10. Agreed.</p>	<p>Additional information will be provided in annual outturn report against 2007/08 plan in September 2008 and for 2008/09 in all quarterly monitoring reports. Head of Internal Audit.</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
Performance, quality and effectiveness			
<p>Internal audit carries out the annual assessment of the effectiveness of internal audit.</p> <p>Internal audit calculates performance against a set of performance indicators and reports performance annually to Audit Committee. In view of our other findings, it is timely that a refreshed set of key performance indicators is agreed with management and the Audit Committee, and performance against these indicators is reported more frequently.</p>	<p>11. The Council should consider the use of an alternative means of performing the annual assessment of internal audit.</p> <p>12. Internal audit should report more frequently against a revised set of key performance indicators, agreed with management and the Audit Committee.</p>	<p>11. Agreed in principle. The review will inevitably draw heavily on the work and outputs of Internal Audit but an element of independent (but internal) scrutiny will be included.</p> <p>12. Agreed - will review PIs used for the future and implement alongside quarterly monitoring and reporting of performance against audit plan.</p>	<p>City Treasurer and Assistant Chief Executive (Performance). March 2009.</p> <p>City Treasurer and Head of Internal Audit. Revised KPIs to Audit Committee, September 2008. Quarterly monitoring thereafter.</p>

Findings by Code of Practice area	Recommendations	Management response	Implementation details
Audit Commission report - January 2008			
<p>Internal audit has, so far, made little progress in implementing the action plan arising from last year's Audit Commission review. This is understandable given the position on internal audit resourcing. (Recommendations not repeated here.)</p>	<p>13. Internal audit should implement the action plan agreed with the Audit Commission as part of its programme of improvement actions.</p>	<p>13. Agreed, although some recommendations have already been implemented. The improvement plan needs to be updated and revised timelines agreed. Dedicated resource is required to enable this work to be completed and this will be identified specifically in the audit plan for 2008/9.</p>	<p>Head of Internal Audit - October 2008.</p>



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