audit 2001/2002

Review of Internal Audit

City of Salford

INSIDE THIS REPORT

PAGES 2 - 3

Summary Report

PAGES 4 - 10

Detailed Report

- Main findings

PAGES AP 1 – AP5

Action Plan

DISTRICT AUDIT

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Introduction

Internal Audit is a statutory responsibility under Section 151 of the Local Government Act 1972 and the accounts and Audit Regulations. It is defined as:

'An independent appraisal function established by the management of an organisation for the review of the internal control system as a service to the organisation. It objectively examines, evaluates and reports on the adequacy of internal controls as a contribution to the proper, economic and effective use of resource'.

Part of our responsibilities under the Audit Commission Code of Practice is to determine whether the Council has adequate arrangements for ensuring systems of internal control are both adequate and effective. Internal Audit performs a key review function in this area; thus we seek to assess whether they are an effective control.

Background

The Internal Audit Section at Salford City Council has 33 full time equivalent staff who are divided into five teams. These are mainstream, computer/contract, investigations/consultancy, energy and Greater Manchester Police. The audit of the Police Authority is provided under a service level agreement. This structure is currently under review due to the imminent departure of three staff members.

Internal Audit has been subject to significant change over the last five years. The Section has modernised its audit approach by developing a new methodology that focuses audit resources on areas of greatest financial and operational risk.

Audit approach

Our audit approach was to assess Internal Audit against statutory guidance and good practice standards (as specified by CIPFA). Our review covered the following areas:

- objectives and scope
- independence
- staffing and training
- relationships
- due care
- planning
- controlling
- recording
- evaluating internal control
- evidence
- reporting and follow up

Our work comprised of discussions with the Chief Internal Auditor and key staff together with a review of documentary evidence. We also made an assessment of a sample of internal audit reviews.

The work of the Energy Audit and Police Teams were excluded from this review. Greater Manchester Police are subject to a separate audit although, as all the teams within the Internal Audit Section are inter-related, findings from the Police audit work have been taken into account when carrying out the current exercise.

Main conclusions

Our overall conclusion in that on the whole Internal Audit complies with the statutory guidance and professional standards. We found many examples of good practice including the:

- strategic planning process which is based on a formal identification and evaluation of the risks to which the Council is exposed
- risk based approach to carrying out individual audit assignments
- extensive use of IT to maximise the effectiveness of the Section
- internal training programmes held for new and existing staff
- pro-active approach to newly developing areas such as corporate governance and risk management.

The Internal Audit Section also achieved 100% of the 2001/2002 audit plan although some of the time charged relates to over-runs from the previous year when the budgets were insufficient for the work required on the new financial systems. Nevertheless this is a vast improvement on performance in 1997/1998 when we last carried out a review. In 1997/1998 the Section only delivered 50% of the plan and this was threatening to seriously undermine its effectiveness. The improvement is largely due to:

- ring fencing the resources used on the Greater Manchester Police audit so that the problems of staffing shortages are shared more evenly between the teams
- using agency staff to cover for temporary staffing shortages.

We found that there was a major problem with delays in implementing some of Internal Audit's recommendations. Several draft reports on the Authority's new financial systems were issued between October 2001 and January 2002. Despite numerous reminders from Internal Audit, they had not been agreed with management by the time we carried out our review in June 2002. We understand that this was partially due to the work pressures facing the Financial Services Group. However failure to act on the reports, which contain many recommendations requiring urgent action, leaves the Authority's systems vulnerable to error and open to the risk of abuse. There are examples of incorrect payroll and creditor payments being made due to the absence of controls.

The delay has also had a knock on effect on the audit coverage of these new systems in 2001/2002 which was put on hold pending management's response. This, together with other factors such as postponing the housing benefits work due to the BFI inspection, has meant that audit testing to identify whether key financial controls have been operating throughout the whole of 2001/2002 was inadequate. Internal Audit recognises the problem and plans to undertake further work by September.

The way forward

We have made a number of recommendations for improvement in the attached Action Plan which has been agreed with the Authority.

SECTION 1

Main findings

Objectives and scope

1. The terms of reference for the Internal Audit section are included in the Council's Financial Regulations. A Mission Statement and Internal Audit Charter both of which have been approved by the Audit Committee supplement these. All these documents meet the good practice requirements set out in legislation and professional standards. Furthermore, as mentioned earlier, the Section have been innovative in adopting a truly risk based approach to their work which means that they examine all operational risks not just those of a financial nature.

Independence

2. Independence enables internal auditors to appraise the internal control systems in an impartial and unbiased manner which is essential to the proper conduct of audits. Recognition of the independence of internal audit is fundamental to its effectiveness.
3. Salford's Internal Audit Section does not have any non-audit duties that might compromise its independence. With regard to reporting lines, the Chief Internal Auditor is responsible to the Director of Corporate Services although he has direct access to the Chief Executive should this be required. In addition the Internal Audit Charter gives him open access to the Audit Committee.
4. Our review of Internal Audit's work did not identify any instances where the scope of their work or the conclusions reached were unduly compromised

Staffing and training

5. The internal audit function should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditors should be properly trained to fulfil all their responsibilities.
6. The Internal Audit Section is likely to be restructured in the near future as three staff members, including an audit manager, are leaving. The Chief Internal Auditor is currently considering the various restructuring options available to him. In addition to staff departures, the restructure will be examining the Section's capacity to play a key role in developing areas such as corporate governance and risk management.
7. The Chief Internal Auditor is a qualified accountant and has significant experience in internal audit within local government. The Audit Manager responsible for the Salford City Council audit has been in post for a number of years and is also a very experienced auditor. The remaining staff within the Mainstream Team have a great deal of audit experience although only one has a professional accountancy qualification.

8. During 2001/2002 the Internal Audit Section strengthened the professional mix of its staff by employing two agency staff on a temporary basis both of whom were qualified accountants. We recognise that a professional accountancy qualification does not ensure a good auditor although it will give rise to the following benefits:
   - raising the status of the Section
   - encouraging a professional and disciplined approach
   - providing a wider understanding of local authority finance
   - encouraging continued professional development.
9. We therefore recommend that the Section considers ways of increasing the level of professionally qualified staff through measures such as creating the right environment for existing staff to seek qualifications or by bringing in qualified staff either on recruitment or rotation.
10. The Salford City Council audit also has significant input from staff on the specialist Computer/Contract Audit and Investigations Teams. Salford is fortunate to have this level of specialist support as often these skills are in short supply. However the Audit Manager responsible for Computer/Contract Audit will be retiring at the end of June 2002 and, as mentioned earlier, the Chief Internal Auditor is currently examining how his expertise will be replaced.
11. Staff need to receive training that helps them to meet the challenges of their role. Training is particularly important in Salford as the risk based approach places a great deal of reliance on the expertise of individual auditors. The Internal Audit Section has appointed a training officer to assess needs and develop training. She is currently on secondment but will resume her training duties once she returns to Internal Audit in October 2002.
12. Internal Audit has adopted the Council's staff appraisal scheme which involves carrying out an annual review to identify development needs. This is followed up by periodic, ideally quarterly, updates. These appraisals have identified training needs and the Section is currently considering how these can be best addressed.
13. At present all new members to the Internal Audit section are provided with an induction pack, training on the risk based methodology and time to work alongside an experienced auditor to see the approach operating in practice. The Section is also proactive in organising internal training courses as a refresher for existing staff or to introduce new procedures. The latest round of internal training is planned for June 2002.

Recommendations
R1 Audit Management should consider ways of increasing the level of professionally qualified staff.

Relationships

14. An internal audit service should seek to foster constructive working relationships and mutual understanding with management, with external auditors, with any other review agencies and, of particular importance, with the Audit Committee. However the auditor should not allow objectivity to be impaired.
15. Internal Audit has done a lot to foster good working relationships with management in recent years. The strategic plan is agreed in consultation with directors and the views of management are taken into account throughout the whole audit process. The success of this approach is reflected in the results of the client feedback most of which rates the service as good.

16. Internal Audit attends the Audit Committee on a quarterly basis to report progress against the operational plan and the results of the audit work carried out. The Chair of the Audit Committee also receives copies of all internal audit reports issued. One way in which the current arrangements could be strengthened further is by producing an annual report summarising the year's work. This could include information not currently incorporated in the quarterly reports, such as performance indicators. Good practice also suggests that annual reports should include the auditor's view on the organisation's internal control systems.

17. We have established good working relationships with Internal Audit and hold regular liaison meetings with key staff. Internal Audit also carry out work as part of the 'Managed Audit' which means that we can take assurance from their coverage of key systems. Where appropriate we work jointly with Internal Audit and this year we are working together on reviewing the Council's risk management procedures. Our arrangements for working together are set out in an agreed protocol which is currently being updated.

Recommendations
R2 The Internal Audit Section should produce an annual report that includes information such as performance indiicators and a view on the Council's internal control systems.

Due Care

18. Clients of internal audit services and others who wish or need to draw conclusions from internal audit work are entitled to expect that the auditor has taken proper care. Internal audit should have procedures in place to ensure that high professional standards are followed, including an effective quality assurance system.

19. Internal Audit ensures that professional standards are maintained by adopting a standard approach that is set out in the Section's Methodology Manual. The approach incorporates supervisor review at all the key stages of a job to ensure that the set down procedures are applied in practice. A team leader, principal auditor and audit manager review individual jobs. Whilst we recognise that review is essential, involving three people in this task does appear to be excessive. We therefore recommend that the review procedures are examined and, if possible, rationalised.

20. As mentioned earlier, there is also an independent quality review process which involves sending out questionnaires to clients following each audit. This is a good method of obtaining feedback but the Section does not follow up questionnaires that have not been returned. The current response rate to questionnaires is approximately 50%. The questionnaires are tracked on a computerised spreadsheet and we feel that there is scope to enhance the information recorded so that it automatically provides a more meaningful analysis of the results.

Recommendations
R3 Job review procedures should be examined with a view to reducing the number of staff involved.
R4 Quality control questionnaires that have not been returned should be followed up.
R5 Consideration should be given to extending the ocmputerised record of questionnaires so that it can provide a more detailed analysis of the results.

Planning

21. It is important for internal audit to plan effectively to ensure that they contribute to the organisation's objectives at strategic and operational levels. Planning also enables internal audit to demonstrate both internally and externally that they are making the best use of scarce resources.

22. Salford follows the good practice guidance on planning. The strategic plan is prepared using a computerised package, Risk Ranking Advisor (RRA), which is based on a formal identification and evaluation of the risks to which the organisation is exposed. The plan:

- sets out which major areas of activity will be audited over a four year period (2001/2002 to 2004/2005)
- is agreed with the Audit Committee
- is translated into annual operational plans which are used to monitor progress on a regular basis throughout the year
- is flexible enough to allow Internal Audit to respond to changing priorities as it is updated after each audit assignment.

Controlling

23. The work of internal audit must be controlled at each level of operation to ensure that adequate levels of performance are achieved.

24. At the highest level the Audit Committee monitor the delivery of the annual plan. On a day to day basis Audit Managers monitor progress weekly using information from the Section's management information system (AMIS). The information produced is very comprehensive and shows the latest position on individual jobs.

25. Our review of actual performance against the 2001/2002 audit plan showed that 98% had been achieved by the end of March 2002 and 100% by April 2002. This is a vast improvement on performance in 1997/1998 when we last carried out a detailed review of Internal Audit. In 1997/1998 the Section delivered only 50% of the plan and this was threatening to seriously undermine its effectiveness. Internal Audit are to be congratulated on this improvement which is largely due to:

- ring fencing the resources used on the Greater Manchester Police audit so that the problems of staffing shortfalls are shared more evenly between the teams
- using agency staff to cover for temporary staffing shortages.

26. We also found that a number of the jobs for 2000/2001 and 2001/2002 had significantly over-run their budgets. This was largely due to the budgets for the financial systems in 2000/2001 being insufficient given the scale of the changes that had taken place. As a consequence some of this over-run has been charged against the 2001/2002 budget. In addition it is acknowledged with hindsight that some of the budgets set out in the new strategic plan for 2001/2002 were unrealistically tight.

27. Audit Managers have taken this on board for 2002/2003 and have allocated more realistic budgets. In addition the controls over allocating additional time from the central contingency to individual jobs have been strengthened so that there is a proper record of authorised changes to the plan. We also suggest that progress monitoring reports identify the financial year to which the audit testing of key financial systems relates so that the level of coverage over years is easily understood.

Recommendations	
R6	Progress monitoring reports should identify the year to which the testing of key financial systems relates.

Recording and evidence

28. Internal audit work must be documented clearly at all levels so that any reviewer can follow the logical flow from audit planning through to assignment completion and reporting. Salford uses a computerised system (RACE) to produce standard working papers and record results. RACE is going to be replaced by an updated system (Pro Audit Advisor) in 2002/2003. The new system has many enhanced facilities that should lead to efficiency improvements for the Section.

29. We reviewed a sample of seven internal audit jobs and found that on the whole they showed adequate systems coverage and supporting evidence. However it was not always possible to ascertain exactly what work had been undertaken without discussing the job with the auditor. In particular we found that:

- the approach to mapping systems was not consistent across jobs
- evidence that all risks had been considered and ranked appropriately was not always included in the file
- links between the risks and the systems diagram were not routinely made
- referencing of testing to supporting evidence could be improved
- standard working papers were not fully completed eg jobs signed off as reviewed, review points cleared.

30. The need to document the assessment of risk is particularly important given the audit approach in Salford. The success of the job depends entirely upon a proper assessment and evaluation of risk. It is therefore essential that the rationale behind this assessment and where the risks in the system lie are clearly evidenced.

Recommendations	
R7	A consistent approach to system mapping should be adopted.
R8	Risk assessments should be clearly evidenced and referenced to the system documentation.
R9	Supporting evidence should be clearly referenced to tests.
R10	Staff should be reminded of the need to fully complete all working papers.

Evaluating internal control

31. It is internal audit's responsibility to evaluate systems of internal control, its scope should include examining and evaluating the whole system of internal controls established by management and not just the financial control system. The evaluation of controls should be done against an assessment of the risks facing the organisation.

32. Clearly Salford's risk based approach meets the good practice criteria. However, our review showed that there were some problems with the level of coverage of key financial systems in 2001/2002. As mentioned earlier, due to over-runs, most of the work charged to 2001/2002 relates to the previous financial year. Internal Audit have not examined the operation of key financial controls throughout 2001/2002 due to a combination of the following factors:

- delays in agreeing the 2000/2001 audit reports on the payroll, creditors and debtors systems which meant that testing in 2001/2002 could not commence
- postponing housing benefits testing due to the BFI inspection
- confusion between the Audit Manager and staff that meant that post implementation reviews rather than full audits were carried out on the housing rents, NNDR, and council tax systems.

33. Good practice suggests that testing should ensure that key controls have been operating throughout the main financial systems for the whole of the financial year. Internal Audit recognises that the current level of testing cannot give this assurance for 2001/2002 but plan to carry out further work by September 2002.

34. When Internal Audit first introduced their risk based approach they expected to be able to rely upon directorates' own monitoring systems thus reducing the number of establishment visits they undertook themselves. Experience over the years has shown that this is not always the case and, as a result, Internal Audit are planning to increase the amount of time they spend visiting Council establishments such as schools and care homes in 2002/2003.

35. The only area in which they plan to rely upon directorates is Leisure who employ a member of staff to monitor leisure centres. If Internal Audit are to place reliance on this officer it is essential that they review the adequacy of the work undertaken. We also note that Internal Audit have developed a standard work programme for school visits which has been very successful in maximising the use of audit resources. We understand that there are plans to produce similar programmes for other establishment visits and recommend that this is done.

36. Internal Audit currently spends a lot of time investigating allegations of fraud that have been brought to their attention. Consequently most of their fraud work tends to be re-active rather than pro-active. The Section recognises this and intends to try to free up some resources to carry out planned fraud identification exercises in the future. We support this proposal.

Recommendations
R11 Testing of key financial systems should identify whether controls have been operating throughout the system for the whole of the financial year.
R12 Where reliance is being place on the control operated by directorates, these should be reviewed to ensure that they have been working in practice.
R13 Work programmes should be developed for all establishment visits.
R14 Internal Audit should undertake pro-active fraud investigation work as planned.

Reporting and follow up

37. Internal auditors should ensure that findings, conclusions and recommendations arising from each audit assignment are communicated promptly to the appropriate level of management and that a response is actively sought. They should ensure that arrangements are made to follow up audit recommendations in order to monitor the effectiveness of action taken.

38. Internal Audit have agreed formal reporting arrangements, including those for follow up, with senior managers within the Authority and the Audit Committee. In addition a standard reporting format has been adopted. This clearly sets out the objectives of the audit, scope of work, findings (summary and detail), recommendations and an agreed action plan.

39. Internal Audit's own performance indicators require draft reports to be issued within ten working days of completing the fieldwork. The latest monitoring report shows that on average this is taking thirty-six days due to sickness and holidays. We therefore recommend that every effort is made to ensure that draft reports are issued promptly following completion of the fieldwork.

40. We also found that Internal Audit had experienced significant delays in agreeing several of their key reports with management. In particular the reports on the Authority's new financial systems had not been agreed at the time of our audit (June 2002) even though they had been issued at least five months ago – accounts receivable (issued October 2001), accounts payable (issued December 2001) and payroll (issued January 2002). Other key reports still outstanding related to taxation and VAT (issued February 2002) and SAP training and development (issued April 2002).

41. The failure to agree these reports is a significant problem as they contain many recommendations that require urgent action in order to rectify system weaknesses. The reports show that, for example, the:

- internal procedures currently being operated within the payroll system would not prevent employees being paid incorrectly and there are at least two examples of large overpayments being made to staff
- controls within the accounts payable system would not prevent incorrect payments being made to suppliers with Internal Audit finding examples of erroneous and duplicate payments
- payroll control account has not been reconciled and contains a large unexplained balance that could lead to unexpected charges to the revenue account
- need to review the workload of the E-merge Team as it is unable to adequately support system users with the existing resources.

42. The Internal Audit Section has followed up all the reports on numerous occasions but has not been able to secure a response. We understand that this is partially due to the work pressures currently facing the Financial Services Group following the introduction of the new financial systems. However failure to act on the Internal Audit's recommendations leaves the Authority's systems vulnerable to error and open to the risk of abuse.

43. We therefore recommend that the Authority implement Internal Audit's recommendations as soon as possible. We also recommend that Internal Audit agree a protocol with directorates whereby they will allow a reasonable amount of time for a management response. However if a response is not received within this timescale the report will be published anyway. This will bring significant issues into a wider domain and alert senior members and officers to the situation.

Recommendations
R15 Every effort should be made to ensure that draft reports are issued within ten working days of completing the fieldwork.
R16 The Authority should act upon the recommendations contained in Internal Audit's outstanding reports on key fianancial systems.
R17 Internal Audit should publish key reports without a management response if this has not been forthcoming within a reasonable timescale.

APPENDIX 1

DA Head A

DA Head B