



National Audit Office

REPORT BY THE  
COMPTROLLER AND  
AUDITOR GENERAL

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SESSION 2012-13

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HM Treasury

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# The effectiveness of internal audit in central government

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National Audit Office

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HM Treasury

# The effectiveness of internal audit in central government

Report by the Comptroller and Auditor General

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National Audit Act 1983 for presentation to the House of  
Commons in accordance with Section 9 of the Act.

Amyas Morse  
Comptroller and Auditor General  
National Audit Office

1 June 2012

This report examines the effectiveness of internal audit across central government. It covers the main departments plus their associated arm's-length bodies.

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The National Audit Office study team consisted of:  
Hannah Dicker, Rachael Foster,  
Rachel Kift and Marcus Popplewell,  
under the direction of Andrew Baigent.

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National Audit Office website at  
[www.nao.org.uk/internal-audit-2012](http://www.nao.org.uk/internal-audit-2012)

For further information about the  
National Audit Office please contact:

National Audit Office  
Press Office  
157–197 Buckingham Palace Road  
Victoria  
London  
SW1W 9SP

Tel: 020 7798 7400

Enquiries: [www.nao.org.uk/contactus](http://www.nao.org.uk/contactus)

Website: [www.nao.org.uk](http://www.nao.org.uk)

Twitter: @NAOorguk

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## Key facts

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**£70m**

estimated spend on internal auditors across central government

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**400**

bodies in central government with an internal audit service

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**£666bn**

expenditure in central government bodies where internal audit operates (as stated in the Whole of Government Accounts 2009-10)

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**£13 million** value of internal audit services which are provided by contractors

**£582 billion** income in central government bodies where internal audit operates (as stated in the Whole of Government Accounts 2009-10)

**£1,208 billion** assets in central government bodies where internal audit operates (as stated in the Whole of Government Accounts 2009-10)

**40 per cent** proportion of key internal audit users responding to the National Audit Office consultation who considered internal audit added substantial value to their organisation

**74 per cent** proportion of heads of internal audit responding to the National Audit Office consultation who were satisfied with the frequency with which internal audit was called on for advice or assistance

# Summary

**1** Internal audit in central government should provide independent and objective assurance to the most senior management of public bodies that their systems and controls are fit for purpose. That assurance should cover the controls over core systems, governance and risk management processes including financial and operational controls. At the heart of this governance work is assurance on management's controls over the quality of the information which the accounting officer, the board and the wider business use to make decisions and monitor performance. As government redefines its operating models and looks to cut the fiscal deficit, internal audit needs to recognise these changes and have the capability to respond.

**2** A good internal audit service gets to the heart of the issues facing the organisation. By directly reporting to the accounting officer internal audit is able to give honest and clear information without being influenced by other senior staff seeking to manage the message. In doing this work, internal audit has the responsibility to act as the 'eyes and ears' of the accounting officer in the organisation providing an independent view of where better management of risk can improve organisational performance.

**3** The Treasury requires all central government bodies to have an internal audit function. The size and shape of internal audit varies from large multi-organisational functions to very small teams providing assurance to a single accounting officer. The Treasury estimates that internal audit employs some 1,000 staff across 400 organisations, with additional staff providing assurance services of a similar nature but which are not formally part of internal audit. The Treasury estimates that internal audit costs around £70 million a year.

**4** HM Treasury is responsible for setting standards and policies for central government internal audit. It recognises that internal audit needs to improve and has commissioned a programme to transform internal audit in government, with an implementation date from March 2013.

**5** This report examines the effectiveness of internal audit across central government. It covers the main departments plus their associated arm's-length bodies. This report does not attempt to establish the effectiveness of individual internal audit teams but rather to assess whether internal audit generally provides an effective service for government. To provide a framework for this assessment our report uses a set of characteristics, based on our review of good practice, describing an effective internal audit service. Our assessment is based on consultation with the main internal audit stakeholders, such as accounting officers and chairs of audit committees, heads of internal audit, and the reviews of internal audit's work we carry out every year as part of our audit of central government bodies' financial statements. Our findings are grouped into three sections: whether internal audit sets the right strategy and produces good quality work (Part Two); whether its people have the right capabilities (Part Three); and whether it adequately assesses its performance (Part Four).

## Key findings

**6** In the *Government Internal Audit Standards* the Treasury sets a high level definition of internal audit, but this is not sufficient to set a clear expectation of what an effective internal audit service should deliver.<sup>1</sup> The *Government Internal Audit Standards* define internal audit as “an independent, objective assurance and consulting activity designed to add value and improve an organisation’s operations”. Internal audit should be integral to the management of an organisation, assuring the management information used to run it and acting as the ‘eyes and ears’ of senior staff and the board. It is also a core element of internal control, assuring management that its governance and control systems are fit for purpose and therefore enabling effective accountability for its activities. However, Treasury guidance is not sufficiently specific in setting the expectations of an internal audit service.

**7** Expectations of internal audit are therefore unclear, which leads to a wide variation in how the overarching standards are applied. Our reviews of internal audit plans show that there is little consistency in the application of standards by internal audit. They confirm senior stakeholder views that, in some cases, there is too much emphasis on auditing the high-level risks faced by the organisation, with not enough emphasis on core information and other systems. In other cases internal audit is seen as auditing low-level process and procedures without considering more strategic issues. Whilst there is no ‘one size fits all’ programme of work, we consider that the current average percentage of time spent on assurance of core systems is not sufficient.

**8** Chairs of audit committees and other senior stakeholders expect more from their internal audit service. Forty per cent of respondents to our consultation considered internal audit added substantial value to their organisation, with a further 44 per cent believing it added some value. Despite these views, stakeholders told us they expect more from their internal audit and had concerns over the current depth of insight, relevance and underlying execution of internal audit work. Many key stakeholders believe that internal audit workplans are not sufficiently tailored to be relevant to the different issues facing individual organisations.

**9** Variations in quality and coverage mean that we are often not able to rely on internal audit work to support our external audit. Our reviews of the adequacy and coverage of internal audit, as a routine part of our external audit of around 400 public bodies’ financial statements, show that its work is often of insufficient scope or quality for us to place reliance on it in the areas we would expect to for our external audit work. In part, this is because there are inadequate detailed operational standards for internal auditors on what constitutes a good quality audit, including expected standards of evidence, analysis and documentation. This leads to a lack of consistency across internal audit services and variable quality in audit reports and the assurances given.

1 HM Treasury, *Government Internal Audit Standards*, February 2011.

**10 There are some specific areas where internal audit could be more effective.**

Users see that there are areas where internal audit could provide wider and more relevant assurance. In response to our consultation they identified particular gaps in: the usefulness and relevance of reports; the expertise of staff, including expertise on IT-based information systems; identifying efficiencies in the organisation; the ability to offer advice to senior management; and acting as their 'eyes and ears' in the organisation to highlight key issues. They also thought that internal audit could often be more productive. Our value-for-money studies, such as the procurement of Type 45 destroyers and the development of new fire and rescue regional control centres, have identified many instances where there has been poor value for money because core systems have not provided sufficiently realistic, robust or comprehensive information to allow effective oversight and decision-making. In many cases these weaknesses have not been identified by internal audit.

**11 Many stakeholders believe internal audit can only deliver more value if it increases its capability and capacity.** Our consultation found that 41 per cent of stakeholders thought some or substantial improvement was needed in the expertise or professionalism of internal audit. These findings were reinforced by the stakeholders and heads of internal audit we interviewed who saw significant skills gaps in the capability of internal audit staff. We would expect internal audit staff to have the professional skills and competencies to undertake high quality, rigorous internal audit engagements and the ability to recognise the need for and commission specialist support where necessary. They also need to have the skills to influence senior colleagues based on the relevance and credibility of their work.

**12 HM Treasury's Internal Audit Transformation Programme is a partial solution to the issues we set out. However, the Programme does not consider, in sufficient detail, what should be expected of an effective internal audit service.** The Programme has concluded that the strategy, people, resourcing model and structure of internal audit are not well aligned to deliver cost-effective assurance to accounting officers, audit committee chairs and other senior stakeholders. A key part of the Treasury's solution is to develop 'virtual groups' of internal audit services covering more than one organisation. However, the Treasury has not yet set out a strategic view on the role, quality and coverage of internal audit. Nor does it yet have an accurate view of the costs of internal audit in government. Whilst reorganisation along the lines of the Treasury proposals may lead to improvement, it will only do so if Treasury sets out a clear view on the purpose of internal audit, how it fits into overall management and governance of the organisation and therefore has a clear understanding of what an effective and efficient internal audit service should provide.

**13 Internal audit lacks sufficiently strong leadership and there is little cross-government information on the performance of internal audit.** Few internal audit services assess and report their performance and there are few measures which can be used to compare performance between different internal audit providers. Although the Treasury provides guidance in the form of overarching standards and practices, and heads of internal audit meet from time to time, these roles are not structured in a way which promotes cohesive leadership of the profession. In contrast, the finance profession in government is led by a 'Finance Leadership Group' comprising of the most senior Finance Directors-General, and led by one of their number. This group has been successfully leading actions to improve financial capability and performance.

### **Conclusion on value for money**

**14** Internal audit, which costs around £70 million a year, is a key element of the internal control structure in government. It should provide valuable insight to accounting officers and boards on the effectiveness of their internal controls and what is happening in their organisations. However, government does not get value for money from its internal audit service. Its quality is variable, it does not consistently focus on key risks and its senior customers are not sufficiently clear about what they should expect from effective internal audit. To meet this need internal audit must provide a higher level of assurance to senior management and boards across government.

### **Recommendations**

**15** We make the following recommendations to improve the value for money of internal audit in central government:

- a** **HM Treasury should set out a clear strategic view on the role of internal audit and the expected scope and quality of internal audit services. This vision should be clearly sponsored by senior users of internal audit, including accounting officers and the chairs of audit committees.** This vision will provide a clear basis for achieving improved quality and effectiveness in internal audit and allow users to have a clear and consistent expectation of the level of service.
- b** **Accounting officers and other senior users should set clear expectations, based on the Treasury's strategic view of the role of internal audit, for the level of service they expect and set up mechanisms to monitor performance.** The Treasury should support accounting officers by building a common understanding of the assurance which an effective and efficient internal audit service can and should provide. Management are often not sufficiently aware of what an effective internal audit service can and should deliver and therefore are not sufficiently engaged with or demanding of their internal audit service.

- c** The Treasury should empower a group of the most senior heads of internal audit to provide collective professional leadership and guidance on professional excellence for internal audit and give them the remit to improve internal audit capability and monitor performance. This group would provide the clear leadership for internal audit in government necessary to improve efficiency and effectiveness of the service. The Treasury should work with the Heads of Internal Audit Group to develop and promote guidance on setting the scope of internal audit work. The guidance should stress the importance of internal auditors using their professional expertise to drive audit strategies. The best heads of internal audit use their judgement to ensure an appropriate balance of work, building on and supplementing comments from senior management. Where internal audit does not use its professional judgement, strategies can fail to provide a balanced programme which delivers appropriate assurance over the quality of information, core systems and other risks.
- d** In addition to the overarching *Government Internal Audit Standards*, individual internal audit services should adopt detailed operational standards. These should define the expected scope, methodologies and performance criteria for internal audit, which might be common across government. The operational standards should include defined methods of evidence collection, analysis, documentation and quality assurance and encourage independent review of the quality of an internal audit service. The current scope and quality of internal audit is highly variable and often insufficient and clear detailed standards are required to enable professional excellence in internal audit.
- e** The Treasury and Heads of Internal Audit Group should develop a plan to improve the capability of internal audit. The plan should include the most cost-effective way to build specialist skills through in-house or outsourced arrangements. The current capability of internal audit is not sufficient to meet the needs of users, influence senior colleagues and to respond to the changing operating model and delivery mechanisms of government. The Treasury proposals for 'virtual groups' may help improve the capability of internal audit by increasing the pool of staff and encouraging professional development, but this needs to be balanced against the risk that the service becomes more remote from individual accounting officers.
- f** Internal audit services should report performance and be held accountable to a set of performance metrics agreed with their accounting officer and audit committee. These metrics need to be aligned with organisational objectives. The Treasury and Heads of Internal Audit Group should devise common metrics to compare the audit performance and productivity of different internal audit teams. Better metrics would help to reinforce internal audit's relevance to key stakeholders, enhance accountability and foster a culture of continuous improvement.

# Part One

## Introduction

**1.1** Internal audit in central government should provide independent and objective assurance to the most senior management of public bodies that their systems and controls are fit for purpose. That assurance should cover the controls over core systems, governance and risk management processes as well as financial and operational controls. At the heart of this work is assurance over the quality of the information which the accounting officer, the board and the wider business use to make decisions and monitor performance. As government redefines its operating models and looks to cut the fiscal deficit, internal audit needs to recognise these changes and have the capability to respond.

**1.2** The Treasury requires all central government bodies to have an internal audit service.<sup>2</sup> It estimates that there are some 1,000 internal auditors in over 400 internal audit functions costing around £70 million a year, including contractor costs of around £13 million. There are over 1,200 professionally qualified internal auditors in central government, although not all of these are currently working in internal audit. Of these, around 800 have a qualification from the Chartered Institute of Internal Auditors or one of the main accountancy bodies. The rest are either affiliated members or hold another relevant qualification. Internal audit services include grouped teams (which cover the main department and the related arm's-length bodies), large teams covering individual departments and small teams covering individual arm's-length bodies. In some cases, a contractor provides all or part of an internal audit service.

**1.3** The Treasury supports the work of internal audit in central government. The Treasury sets high-level standards and policies for government internal audit and provides good practice guidance. The Head of the Government Internal Audit Profession is a part-time role based at the Treasury. The Treasury publishes the *Government Internal Audit Standards* which define the nature of internal auditing within central government, set the basic principles for carrying out internal audit, establish a framework for providing internal audit services and establish the basis for the evaluation of internal audit performance. In developing its standards and guidance, the Treasury works with a range of bodies from outside government, such as the Chartered Institute of Internal Auditors, the Chartered Institute of Public Finance and Accountancy and the Institute of Chartered Accountants in England and Wales. It has recently set up, along with other standard-setting bodies, the Internal Audit Standards Advisory Board to provide it with independent advice in establishing a public sector-wide set of standards.

<sup>2</sup> HM Treasury, *Corporate governance in central government departments: Code of good practice 2011*.

## The scope of this report

**1.4** This report examines the effectiveness of internal audit across central government. This includes the main departments plus the various arm's-length bodies within their departmental families. Our audit teams review, on an annual basis, the audit strategies and work of internal audit as part of our audit of the financial statements of central government bodies. The report does not attempt to establish the effectiveness of individual internal audit teams but rather to form a view on whether internal audit generally provides a good service for its users. To provide a framework for this assessment, our report uses a set of characteristics, based on our review of current and good practice, and which describe what an effective internal audit service would look like. These characteristics are based on a combination of our consultations with relevant experts, good practice in the private sector, our experience of good internal audit work and guidance from the Treasury and the Chartered Institute of Internal Auditors. Our findings are grouped into three sections:

- whether internal audit sets the right audit strategy and produces good quality work (Part Two);
- whether its people have the right capabilities (Part Three); and
- whether it adequately assesses its performance (Part Four).

Our report methodology is summarised in Appendix One.

## The Internal Audit Transformation Programme

**1.5** In 2009 the Treasury set up the Internal Audit Transformation Programme to improve engagement by management with the performance of internal audit. The Programme was based on an extensive consultation with stakeholders and reviews of internal audit practice. The initial work concluded that the strategy, people, resourcing model and structure of internal audit were not well aligned to deliver cost-effective assurance to accounting officers, audit committee chairs and other senior stakeholders.<sup>3</sup> The main findings were as follows:

- The way internal audit worked across departments and their arm's-length bodies differed greatly in terms of planning, delivery and reporting.
- The views of heads of internal audit and key stakeholders differed, both in their expectations and understanding of the role of internal audit and on the quality of the service being delivered. It was not clear that stakeholders understood what they should expect from internal audit.
- There was no coherent programme in place to develop the people working in internal audit. This limited how well internal audit could attract, develop and retain the high calibre people it needed to interact credibly with top management.

<sup>3</sup> HM Treasury, *Internal Audit Strategic Improvement Plan: Consultation*, January 2010.

**1.6** The Treasury Internal Audit Transformation Programme's high-level objectives are set out in **Figure 1**, as at March 2012. The Programme's issues are explained in more detail in Appendix Two.

**1.7** The Treasury has concluded that the issues identified by the Internal Audit Transformation Programme point to the need for a change in the delivery model applied across central government. The Treasury has proposed that group internal audit services are needed, to create the critical masses required for more flexible and effective use of resources and to develop future leaders. To minimise the costs of establishing groups, the Treasury has suggested that virtual groups are established, whereby existing internal audit services are required to cooperate and share resources in defined groups. The Treasury is currently working on how these 'virtual group' internal audit services could address the issues identified.

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### **Figure 1**

#### HM Treasury Internal Audit Transformation Programme high-level objectives

**High-level objectives:**

- define customer assurance needs and the barriers, risks and benefits to delivering them;
- define the operating model for the government internal audit service, including agreeing at a strategic level the optimum size and shape of internal audit across central government to deliver efficient and effective services;
- ensure the right level of engagement in departments and other government organisations, to enable internal audit to have the required impact; and
- help improve public service delivery, by ensuring sufficient critical masses of internal auditors for career development, growing future leaders, understanding the business, a strategic approach to audit and 'churn' to bring in fresh thinking.

*Source: HM Treasury*

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## Part Two

### Producing good quality work on the right areas

**2.1** To provide the most effective audit service, internal audit needs to give good quality assurance on the accuracy of information and management controls across the activities of the organisation. This work will be risk-based and include assurance on the controls over core systems, reviews of high-level organisational risks and assurance on proposed controls over new activities. The choice of areas on which to focus should be led by the head of internal audit, using his or her professional experience and knowledge, to derive a plan which provides the required coverage.

**2.2** In exercising their professional judgement, the head of internal audit should reflect the needs of the key users of their work, such as the accounting officer, the audit committee, non-executive board members, the finance director and other senior managers (**Figure 2** overleaf). Internal audit's choice of work must also consider the requirements of the various Treasury and professional standards, such as providing the accounting officer with an audit opinion each year.<sup>4</sup>

**2.3** From our review of good practice, we have developed some characteristics that would be expected of an internal audit service that focused its work appropriately and produced good quality outputs which added value (**Figure 3** on page 15). This part of the report sets out our findings on the focus and quality of internal audit's work across government, in the context of these characteristics.

#### Focus of internal audit's work

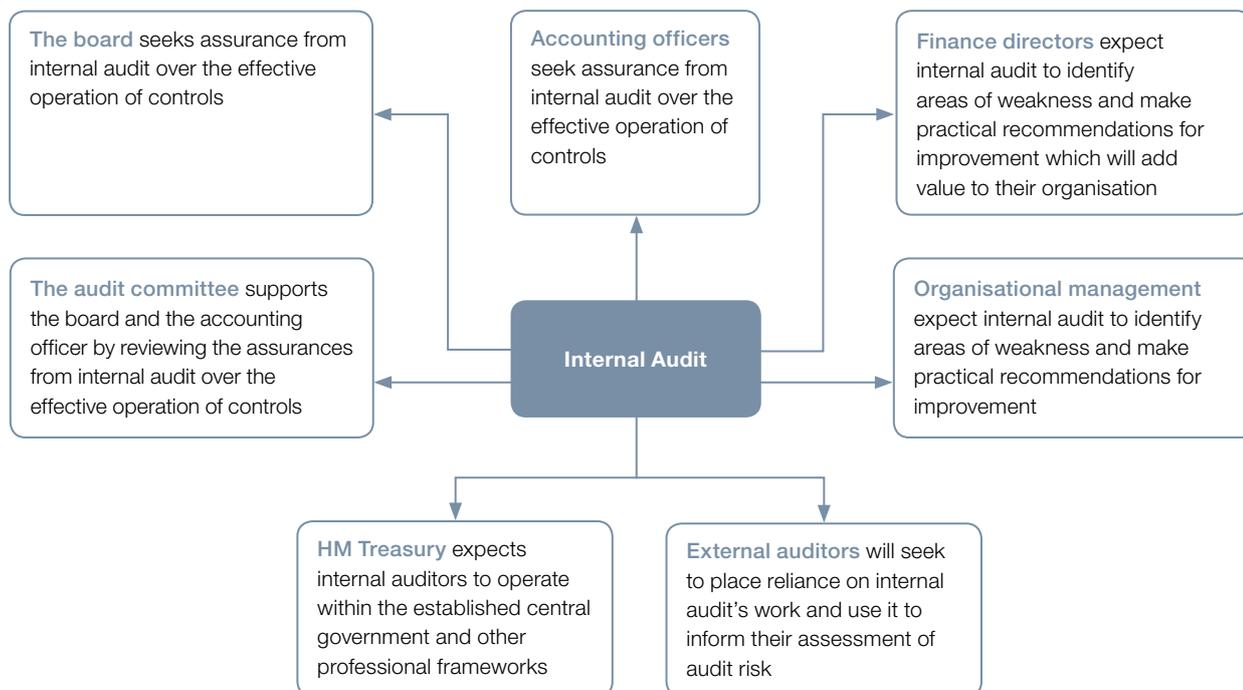
**2.4** Our review of internal audit plans, consultation findings and discussions with stakeholders suggested that, despite the high-level definition in Treasury guidance, there is no clear accepted vision on the role of internal audit and the scope of its work.<sup>5</sup> Whilst there has been progress over recent years, most notably changes to the internal audit standards, the scope of internal audit work is often not driven by a robust analysis of the needs of the organisation.

<sup>4</sup> HM Treasury, *Government Internal Audit Standards*, February 2011. For example, the standards state that "The main purpose of internal audit activity within central government is to provide the Accounting Officer ... with an objective evaluation of, and opinion on, the overall adequacy and effectiveness of the organisation's framework of governance, risk management and control".

<sup>5</sup> HM Treasury, *Government Internal Audit Standards*, February 2011 define internal audit as "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes".

**Figure 2**

Summary of key internal audit stakeholders



Source: National Audit Office

**2.5** We reviewed a sample of the internal audit plans of organisations across central government to identify the areas where internal audit focused their work. We found, generally, an inconsistent and unclear approach to the work being proposed. Some internal audit plans focused heavily on the risks associated with financial compliance and compliance with the requirements of regularity and propriety. We found, on average, around 21 per cent of the proposed number of audit days were allocated to issues identified as organisational risks. Around 23 per cent of audit days were spent on assurance over core systems and 9 per cent on advisory or consultancy work. Most of the rest of internal audit's planned work focused on other aspects, such as business continuity, change management, procurement or project delivery. Around 7 per cent of planned audit days went on administration and overheads, although up to 30 per cent in some cases.

**Figure 3**

## Key characteristics of an effective internal audit service in terms of the focus and quality of its work

An effective internal audit service:

- a** has overall objectives that are fully aligned with organisational objectives and are clear and consistently understood by key stakeholders across the organisation;
- b** clearly understands how its activities contribute to the overall assurance available to management, and identifies gaps in that assurance;
- c** provides robust, evidence-based challenge to management’s response to key organisational risks and is respected and valued by the business for doing so;
- d** works to ensure key stakeholders show an active interest in its work and opinions and is in demand from the organisation to provide objective assurance to key areas of risk;
- e** provides appropriate assurance on controls over core information and other systems, and controls over current and future risks – reporting proportionately and effectively;
- f** provides assurance proactively on change programmes at key stages of their life cycle, to help ensure that risk management and internal control is built in;
- g** considers how its work can provide assurance on controls over common and cross-government risks; and
- h** has an open dialogue to develop and learn, and open communication with its key stakeholders.

*Source: National Audit Office*

**2.6** While there is no ‘one size fits all’ programme of work, we consider that the current average percentage of time spent on assurance on the overall effectiveness of core systems is not sufficient. In many cases there is a focus on low-level compliance testing, which can fail to provide assurance on the system as a whole. Testing compliance with low-level controls is necessary but organisations need overall assurance on core systems and will also have other significant risks that internal audit should consider. Other risks may, for example, relate to controls over delivering major business projects or reputational issues. Internal audit can play an important role in providing assurance to management in such key risk areas. One respondent to our consultation commented “We definitely need to know that our systems are tight and working well but that’s not all we need to know.”

**2.7** The involvement of internal audit in providing assurance on controls over new systems and policies did not appear to be widespread. Only around one-third of the internal audit plans we reviewed included any assignments that indicated this more prospective advisory or consultative role for internal audit. There is an important role for internal audit in these kinds of engagements, advising management on related risks and providing assurance on designing controls, processes and solutions before they are implemented.

**2.8** The focus of internal audit varied greatly across the organisations we reviewed. Outsourced providers and many key stakeholders believe that internal audit workplans are not sufficiently tailored to the different issues facing individual organisations. In some cases stakeholders consider there is too much emphasis on auditing the high-level risks faced by the organisation, with not enough emphasis on core information and other systems. In other cases internal audit is seen as auditing low-level process and procedures without considering more strategic issues. Most internal audit services used the strategic risk register to consider the focus of their work, although these rarely identify the risk arising from core information and other systems. The emphasis on assuring the accuracy of information and management's controls over core systems can therefore be lacking. Our programme of value-for-money studies has identified numerous instances where poor value for money has been secured because core systems have not provided sufficiently realistic, robust or comprehensive information to allow effective oversight and decision-making. These include procuring Type 45 destroyers and developing new fire and rescue regional control centres.<sup>6</sup> We did, though, find examples where the nature and rationale for internal audit's focus was clearly set, such as at Ofcom (**Figure 4**).<sup>7</sup>

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#### **Figure 4**

#### Case study – setting out an appropriate balance of internal audit coverage: Ofcom

The Ofcom internal audit plan for 2011-12 sets out a thorough and comprehensive set of proposals for its coverage, in line with the characteristics shown in Figure 3. For example, the plan sets out:

- how it has been prepared (e.g. consultation with senior management and the audit committee, and a review of, for example, key risks, discussions with the National Audit Office and potential changes in the operating environment);
- the areas where it will seek assurance i.e. core financial processes, operations and IT, and governance and risk management;
- the individual areas on which reviews will be carried out; and
- how progress will be reported to senior management and the audit committee, how that process will be improved and key performance indicators.

#### **NOTE**

1 Ofcom is the independent regulator and competition authority for the UK communications industries.

Source: National Audit Office based on Ofcom internal audit plan for 2011-12

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6 Comptroller and Auditor General, *Providing Anti-Air Warfare Capability: the Type 45 destroyer*, Session 2008-09, HC 295, National Audit Office, March 2009; Comptroller and Auditor General, *The failure of the FiReControl project*, Session 2010-2012, HC 1272, National Audit Office, July 2011.

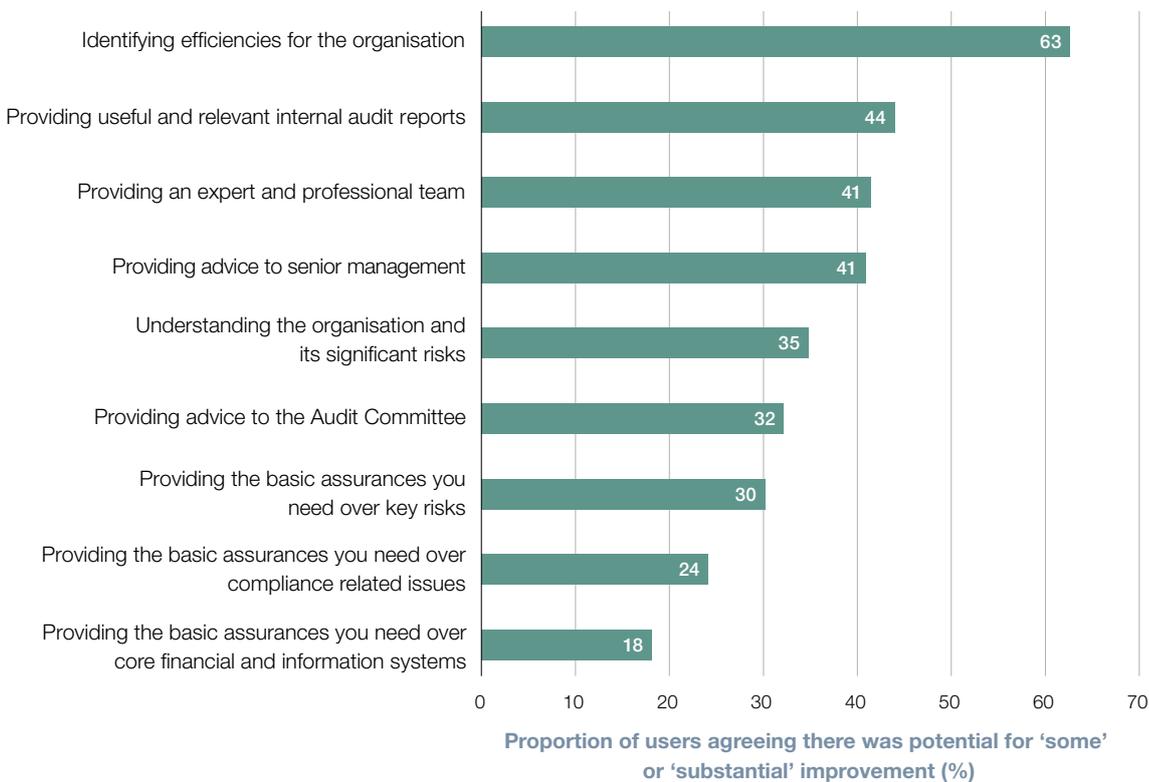
7 Ofcom is the independent regulator and competition authority for the UK communications industries.

**2.9** Users responding to our consultation and our interviewees highlighted a number of areas where they felt there was potential for some or substantial improvement in the work of internal audit (**Figure 5**). The main area where respondents felt internal audit's work could be improved was in helping to identify efficiencies for the organisation. This is particularly relevant while public bodies reduce spending as part of the government's deficit reduction strategy. Our regular engagement with users in our work across government suggests that many are not sufficiently demanding in setting their assurance requirements from internal audit at a level which adequately assures the quality of information and other core systems. Treasury research for the Internal Audit Transformation Programme shows that management are not always aware of what an effective internal audit service can and should deliver.

### Figure 5

Key users' views of the areas with potential for 'some' or 'substantial' improvement in the focus of internal audit

Respondents to our consultation stated that there was potential for improvements in the work of internal audit, particularly in the identification of efficiencies for the organisation



Source: National Audit Office consultation with key users of internal audit

## Quality and added value of internal audit's work

**2.10** We review, every year, as part of our external audit of around 400 public bodies' financial statements, the coverage and adequacy of internal audit's work to see if any reliance can be placed on it.<sup>8</sup> These reviews include an assessment, where appropriate, of whether internal audit's work is properly documented, reviewed and based on sufficient evidence. Our reviews showed that the quality of internal audit's work was highly variable, meaning that in the few areas where we would have wished to place explicit reliance on it we could not. A key reason for the variability in quality is that the standards governing internal audit, such as the *Government Internal Audit Standards*, are not sufficiently explicit in setting out the requirements for collecting evidence, analysing and documenting information or communicating results. It is currently left to each head of internal audit to determine what constitutes a suitable evidence base and to develop their own style of reporting. This leads to a lack of consistency across internal audit services and variable quality in audit reports and the assurances given.

**2.11** Our consultation of 118 key users, such as accounting officers and audit committee chairs, revealed that some 40 per cent considered internal audit added substantial value to the organisation. A further 44 per cent believed that internal audit added some value. In contrast to this positive high-level impression, however, our consultation with key stakeholders also showed that they had concerns over the depth of insight, relevance and underlying execution of internal audit work, linking in with the areas for improvement shown in Figure 5.

**2.12** In our consultation, stakeholders and heads of internal audit believed that there was about the right level of engagement between senior management and internal audit. There was some encouraging feedback to suggest that internal audit received the backing from those at the top of the organisation:

- Twenty-nine per cent of stakeholders thought internal audit's advice to senior management added substantial value, with a further 47 per cent believing it added some value.
- Thirty-seven per cent of stakeholder responses suggested internal audit's advice to the audit committee added substantial value, with a further 46 per cent seeing it adding some value.
- Seventy-four per cent of heads of internal audit said that internal audit's engagement with senior management was at about the right level.

<sup>8</sup> The reviews follow the guidance set out in the auditing standard ISA (International Standards on Auditing) 610 *Using the work of internal auditors*.

## **Assuring controls over common and cross-government risks**

**2.13** Departments face a number of delivery risks that are common to many government organisations. Such risks might include those arising from devolved delivery chains, delivery of cost savings to meet spending targets and the risk of fraudulent claims from the public. An effective internal audit service should recognise these issues, flex their plans to consider the related risks and build on the experience of other organisations facing the same issues. We found little evidence of internal audit services sharing their experiences.

**2.14** The centre of government, including HM Treasury and the Cabinet Office, collect financial and performance information which is used to monitor and manage the performance of government as a whole. We identified only a small number of organisations where internal audit has been tasked with providing assurance on the information provided to the centre of government. However, there is no assurance work on the systems used to control the collation and analysis of this data at the whole of government level. Assurance over these processes and the underlying data would greatly increase the utility of this information.

## Part Three

### Having people with the right capabilities

**3.1** The government is seeking to improve the quality and skills of internal audit staff. The delivery of government operations is becoming increasingly complex, leading to new and different risks. Internal audit needs to respond to these changes to provide an effective assurance service by developing new skills and capabilities, including the ability to influence senior colleagues and assuring controls over the management of significant reductions in public expenditure, devolved delivery models and more complex IT systems. The Treasury provides some guidance for internal audit services. However, this focuses on detailed processes and does not set out an adequate description of the capabilities of an effective internal audit service.

**3.2** From our review of good practice, we have developed some characteristics that would be expected from an internal audit service with the right capabilities (**Figure 6**). This part of the report sets out our findings on the capabilities of internal audit across government, in the context of these characteristics.

**3.3** Our consultation with stakeholders on the capability of internal audit found that 41 per cent thought some or substantial improvement was needed in the expertise or professionalism of internal audit. These findings were reinforced by the stakeholders and heads of internal audit we interviewed who saw significant skills gaps in the capability of internal audit staff. Stakeholders also commented on a perceived lack of productivity from internal audit and a high level of resources used in management and administrative work. In some cases up to 30 per cent of audit days are deployed on management and administration.

**3.4** The general need to improve internal audit's capabilities partly comes from the large number of discrete internal audit functions in government. Across the public bodies we examined generally, we found 57 per cent of internal audit's time (in terms of the number of audit days) was provided by in-house services, 25 per cent by shared services and 12 per cent was contracted-out with the remainder provided from other sources. For departments, we found that 80 per cent of internal audit time was provided by in-house services and the rest from shared services. For other bodies, 34 per cent of internal audit time was provided by an in-house service, with 30 per cent provided by shared services and 24 per cent contracted-out. The remainder was provided from other sources.

**Figure 6**

## Key characteristics of an effective internal audit service with the right capabilities

An effective internal audit service should employ staff or external contractors, or both, who:

- a can provide objective assurance independent of management, report to and influence senior management, and is seen as capable by the rest of the organisation;
- b can influence organisational change by recommending management actions that improve proportionate and effective control and which are implemented in a timely manner; and
- c have the professional skills and competencies to undertake high-quality, rigorous internal audit and can commission and quality assure specialist support where necessary.

In addition an effective internal audit service should be led by a head of internal audit who can:

- d performance manage the internal audit service to align with wider organisational objectives, set staff and contractors clear and agreed performance objectives and use a robust system to track, report and evaluate performance of individual and overall service;
- e develop the competence of staff through training and wider professional development, to facilitate staff career development;
- f provide professional leadership for internal audit, develop a clear business model and operational standards that ensure a fit-for-purpose audit plan; and
- g provide support and information to the accounting officer, acting as their 'eyes and ears' in the organisation.

*Source: National Audit Office*

**3.5** Small, in-house, internal audit functions can build on local knowledge but, because of their size, cannot always attract high-calibre staff and often lack the capability to consider complex projects, automated systems or ICT risks. Large internal audit functions, sometimes serving multiple organisations, can have the breadth and depth of capability to carry out these specialist tasks and provide career structure, but may lack the continuity of organisational knowledge of smaller functions. Outsourced provision, either for the whole or part of an internal audit service, can bring an alternative perspective and additional expertise, but sometimes at a higher cash cost.

**3.6** Responses to our consultation did not suggest any one approach was ideal. Some suggested that combining in-house and outsourced services, adapted to the needs of the organisation, could be very effective. The in-house element of the service had the advantage of knowledge of the organisation; outsourced services could bring an alternative perspective and an additional range of expertise, although sometimes at a higher cost. The following responses to our consultation from stakeholders illustrate the different perspectives:

“Audit requires an understanding of the organisation. It is the balance between internal knowledge and outside expertise that is required. Culture and values of an organisation are not easy to fully understand for an outsider, however professional.”

“A hybrid model using an external firm for general controls and specialists and internal team with expert knowledge of our field works well for us.”

**3.7** In our view, the current capability of internal audit is not sufficiently broad or deep to meet the needs of users, influence senior colleagues, provide assurance over the risks faced by government and respond to the changing assurance needs arising from the government's revised operating model. We would expect internal audit staff to have the professional skills and competencies to undertake high quality, rigorous internal audit engagements and the ability to recognise the need for, and commission, specialist support, where it is necessary.

**3.8** The Treasury has recognised that improving the capabilities of internal audit is a key area for development. In setting out the case for change, the Treasury's Internal Audit Transformation Programme notes that:

- the way internal audit across government works differs greatly, in terms of planning, delivery and reporting;
- stakeholders and heads of internal audit differed in their expectations and understanding of the role of internal audit and the quality of service being delivered; and
- there was no coherent programme to develop people, which compromised internal audit's ability to attract, develop and retain the high-calibre people it needed to interact credibly with senior management.

**3.9** The Treasury's Internal Audit Transformation Programme is, as at March 2012, proposing a range of actions to improve internal audit's capability. These are summarised in **Figure 7**.

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### **Figure 7**

#### HM Treasury suggested actions to improve internal audit capability

- A common approach to recruitment.
- Increasing the perceived value of working in internal audit to other members of the organisation.
- Adopting a process to accelerate developing the most able people.
- Increasing the number of people in internal audit with professional qualifications.
- Greater use of data analysis.
- Greater use of audit management software.
- Creating centres of excellence.

*Source: HM Treasury*

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## Part Four

### Assessing performance

**4.1** Parts Two and Three of this report set out what an effective internal audit should do to achieve an appropriate focus for its work and develop the right capabilities. To meet these objectives, internal audit needs to show that it is providing value to an organisation and continuously improving its effectiveness.

**4.2** From our review of good practice, we have developed some characteristics that would be expected from an internal audit service that rigorously assesses and communicates its performance, and takes necessary action to improve (**Figure 8**). This part of the report sets out our findings on how internal audit across government assesses and reports the effectiveness of its performance, in the context of these characteristics.

**4.3** Effective internal audit depends on processes that encourage continuous performance improvement across all aspects – relations with stakeholders, developing people and audit methodology. Quality should be assessed, internally and externally, against established good practice frameworks and across the whole internal audit function. An example of this is shown in **Figure 9** overleaf.

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#### Figure 8

Key characteristics of an internal audit service which assesses its performance effectively

An effective internal audit function:

- a has an accounting officer and an audit committee that holds it to account for its performance;
- b defines, measures and communicates the value it delivers to the business;
- c has a system of quality assurance, quality monitoring and is reviewed externally by professional peers regularly;
- d sets key performance metrics and performance reporting that clearly shows the assurance provided by the internal audit and how it fits with the overall assurance available to management, its costs and efficiency and the value delivered to the organisation;
- e has a system to monitor the status of actions for management to ensure that they have been effectively implemented or management has explicitly accepted the risk of not taking action;
- f carries out evaluations after each audit to look at lessons learned and best practices for communication across all business units for future audits; and
- g complies with *Government Internal Audit Standards*, Institute of Internal Auditors' or other professional standards and this compliance is periodically assessed and explicitly reported.

Source: National Audit Office

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**Figure 9**

## Case study – reviewing and improving the capability of the Ministry of Defence internal audit

The Ministry of Defence internal audit service reviewed its capability in 2010, after appointing a new Head of Internal Audit. The review was based on assessing capability against the Institute of Internal Auditors (USA) capability model, discussions with internal audit staff, assessing against the Deloitte good practice model and assessing the internal audit service's processes.

Some of the high-level findings of the review included:

Positive findings	Good feedback from customers; opportunity to influence; good working environment; improved quality.
Developmental findings	Low credibility and profile; insufficient value added; audit methods need development; need to report more quickly.

After completing the assessments, the internal audit service prepared a project plan setting out its vision for development and the key tasks needed to improve its capability (such as an 'audit universe' to identify the areas on which to focus work, a new audit charter and objectives, new key performance indicators and new audit methodologies developed with the help of an outsourced expert). The intention was, in three years' time, to get an external reviewer to assess the internal audit service against peers in the public and private sector. The team has also proposed moving to a single internal audit service for the Department to improve efficiency and effectiveness.

*Source: National Audit Office analysis of Ministry of Defence internal audit proposals*

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**4.4** Our review of performance metrics used in internal audit plans suggests there is some way to go for them to be sufficiently comprehensive and aligned with organisational objectives and initiatives, to reinforce their relevance to key stakeholders. Of the 71 internal audit plans we examined for services across government, we found that only 16, including those of four departments, included any form of performance metrics. We identified 54 different metrics used to report performance. The most commonly used metrics were for customer satisfaction, delivering the programme of audits and timeliness of reporting. Only 26 of the plans (37 per cent) included information about the proposed cost of the audit. **Figure 10** shows how far different types of performance metrics were used by different internal audit services.

**4.5** We identified some internal audit services which used performance metrics well. **Figure 11**, for example, shows an extract of the main performance information reported by the Department for Education internal audit service.

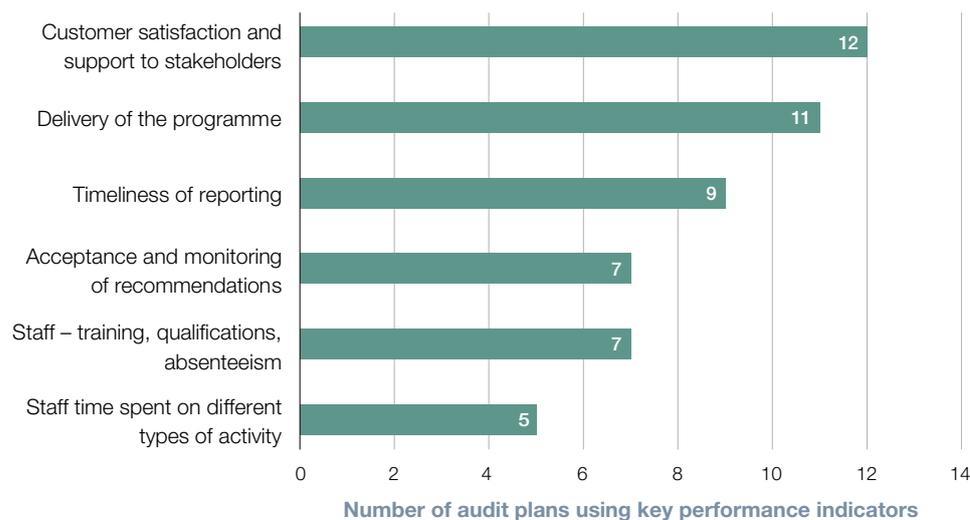
**4.6** Our consultation with stakeholders and heads of internal audit suggested that they would like to see a series of indicators and comparators that would allow benchmarking of performance and compare similar services consistently. Such a development would provide useful indicators of inefficient and ineffective services. Ideally such information would include qualitative, as well as quantitative, metrics.

**Figure 10**

Use of performance indicators by central government internal audit services

**Metrics relating to customer satisfaction and stakeholder support were the most commonly used measures of internal audit performance**

**Key performance indicator categories**



Source: National Audit Office analysis of departmental internal audit plans for 2010-11

**Figure 11**

Case study – extract from performance scorecard from Department for Education internal audit unit annual report

Area	Key performance indicator
Finance	Spend against budget.  Average cost for the unit a day compared with the rate charged to Non-Departmental Public Bodies by outsourced functions.
Staff	Data on recruitment, retirement, promotions and training.
Reviews	Percentage of the initial Top 40 areas for review identified where direct audit work or consultancy has been provided.  Percentage of audits completed/in progress.  Proportion of staff time spent on value added activity versus available hours.  Number of specific actions raised which have been closed.  Feedback from customer surveys.
Other	Regular board briefing activity introduced covering work completed, key issues and a forward look at upcoming reviews.  New audit tools developed and audit and administration processes revised.

Source: National Audit Office analysis of Department for Education internal audit annual report 2010-11

**4.7** Performance metrics are crucial to improving performance and the Treasury should play a key part to encourage reviews of internal audit effectiveness and adoption of good practice. It has recognised the need to encourage continuous performance improvement as part of its Internal Audit Transformation Programme. We see that actions should include:

- developing metrics to measure audit performance which include the productivity of the audit service. The measures would include a series of core measures that can be used to benchmark the audit teams against each other, a further series of common measures so that audit customers can compare their service and a small number of additional measures specific to the organisation. We have set out some suggested metrics in **Figure 12**;
- those leading the development of the internal audit profession being collectively accountable for its development and improvements, and setting expectations over the role of individual heads of internal audit; and
- improving the external quality assurance process based on the models used by the professional accountancy firms and regularly reviewing the overall process of quality assurance.

**Figure 12**

## Examples of good key performance indicators for an internal audit service

**Core performance assessment metrics**

Results of internal and external quality assessments and trend over time

Percentage of time spent on different categories of internal audit work (e.g. core systems assurance, risk, consultancy)

Internal audit budget against outturn

Value (£) of cost savings and efficiencies identified by internal audit

Percentage implementation of recommendations

Timeliness of reporting

Qualitative assessment of impact of recommendations.

**Benchmarking metrics**

(data to include equivalent information from internal audit services across government)

Percentage of staff time spent on direct work

Percentage of professionally qualified internal audit staff

Percentage of internal audit staff with three years or more experience

Average number of training days for qualified/non-qualified internal audit staff

Productivity of internal audit staff

Percentage of internal audit staff turnover.

**Metrics specific to the organisation**

Percentage of audit programme delivered and rationale for any changes to the programme

Assessments of stakeholder views (auditees/board/audit committee/senior management) on satisfaction with the internal audit service, from surveys or direct feedback

Value added by internal audit in £ and as a percentage of the total cost of the internal audit service

Number of requests for ad hoc advice or assistance from management outside of formal meetings.

Source: National Audit Office

# Appendix One

## Methodology

Below is an overview of the methods used in this report. A more detailed methodology can be found on our website [www.nao.org.uk/internal-audit-2012](http://www.nao.org.uk/internal-audit-2012)

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### Method

### Purpose

#### Consultation with users and heads of internal audit

We invited key internal audit users (such as accounting officers and audit committee members) and heads of internal audit to complete an online questionnaire. We had 118 responses from internal audit users and 59 from heads of internal audit.

To gauge the opinions of users of internal audit and heads of internal audit services about the effectiveness of internal audit and what made for a good service.

#### Document analysis

We reviewed a sample of 71 internal audit annual plans, 46 individual internal audit reports and seven internal audit annual reports from bodies across central government (including all 17 Departments and a cross section of 54 arm's-length bodies). This analysis was supported by our annual reviews of internal audit's work for this group of bodies. These reviews are a routine part of our audit of central government bodies' financial statements. We also reviewed documents supporting the HM Treasury Internal Audit Transformation Programme.

To establish data on the type of audit coverage, the rationale and data on the level of activity (such as number of audit days and costs). To establish the quality and impact of internal audit work.

#### Semi-structured interviews

We conducted semi-structured interviews with a small sample of heads of central government internal audit services and National Audit Office client leads.

To gather evidence on the effectiveness of internal audit and what made for a good service.

#### Characteristics of an effective internal audit service

We reviewed good practice in providing an internal audit service, including guidance from the Treasury, the Institute of Internal Auditors, the accountancy institutes and the private sector (including Deloitte, PricewaterhouseCoopers and KPMG).

To provide a set of characteristics to put internal audit across government into context.

#### External expert consultation

We consulted a small group of subject matter experts including the Institute of Internal Auditors and leading accounting and auditing firms.

To give insights into our characteristics of an effective internal audit service and on the findings of our fieldwork.

#### Case studies

We identified case studies from our review of audit documents and interviews.

To illustrate our findings.

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## Appendix Two

### Issues to be addressed by HM Treasury's Internal Audit Transformation Programme

The table below sets out the issues that the Treasury has identified as needing to be addressed by the Internal Audit Transformation Programme, as at March 2012.

Issue	Explanation of issue
Meeting the needs of customers	Customers first and foremost require an effective internal audit service and an annual audit opinion, but are not always clear on the best way to achieve this. The focus of that requirement should be on the improvement of public services not improving internal control for its own sake.
Focusing the work of internal audit	The finite resources available to any internal audit service make it imperative that there are clearly understood mechanisms for directing the resources to the areas of the business where they can add most value.
Cross-cutting risks and issues	Where a risk spans, or is replicated in, multiple central government departments and bodies, a common approach should be taken to manage the risk and there should be a common and efficient approach to assurance on how that risk is being managed.
Developing a consistent service	To improve the efficiency and flexibility of the service, internal audit should develop a best practice approach which is seen to be common across the whole of central government.
Maintaining an appropriate skills base	There are insufficient skills within existing internal audit personnel in central government to meet the current needs of the service and a lack of 'churn' is restricting the impetus for improvement.
Developing heads of internal audit of the future	Succession planning for future heads of internal audit is restricted by the available skills and experience of internal auditors within central government.
Efficient use of people	Internal audit needs to play its part in looking for efficiencies in the service that it can deliver as part of the Spending Review.
Continuous performance improvement	Internal audit, like any other function or discipline, needs to continually develop to both improve its service to customers and to enable it to meet the varying demands of the constantly changing business and political environment.



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