



National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

HC 23
SESSION 2012-13

20 JUNE 2012

HM Treasury

The effectiveness of internal audit in central government

Key facts

£70m

estimated spend on internal auditors across central government

400

bodies in central government with an internal audit service

£666bn

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

£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.¹ 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.