

CONFIDENTIAL

cc Sir Derek Rayner

Mr WHITMORE

BRIEF FOR MEETING ON INTERNAL AUDIT, 18 00, 10 DOWNING STREET,
13 APRIL 1981

DOCUMENTATION

1. I attach the relevant correspondence together with a copy of the final version of the Comptroller and Auditor General's recent report.

BACKGROUND NOTES

2. I also attach background notes on:

(1) The function, status and state of internal audit, including the C&AG's criticism.

(2) Internal audit in perspective.

THE PURPOSE OF THE MEETING

3. The purpose of the meeting might be:

(1) to invite Sir D Wass and Sir I Bancroft to report on the intended programme of reform;

(2) to register the importance the Prime Minister attaches to internal audit as one part of good financial management; and

(3) to indicate how the Prime Minister's interest should be served in future.

← 4. The Prime Minister might like to open by asking Sir D Wass and Sir I Bancroft to bring her up to date. She might then invite observations from Sir D Rayner.

5. The Prime Minister will no doubt wish to emphasise at some point that she sees internal audit as only one part of financial and other resource management. It needs to be set in perspective as but one aspect of the Government's interest in and plan of reform for the totality of management, including its financial basis; the systems for planning, controlling and evaluating the use of resources; and the development of people with the right combination of experience and training to take responsibility for management, both in the line and at the centre within departments. The Rayner "lasting reforms" package is highly relevant to this as is the recent expression of the Prime Minister's decision on the future of the CSD.

THE INTENDED PLAN OF REFORM

6. The essential elements in the letter issued jointly by Sir D Wass and Sir I Bancroft on 20 March are:

- (1) The Treasury will lead. It is the Department principally concerned at the centre with the design and maintenance of the overall system of resource control. The line of responsibility descends from Sir D Wass, through Sir A Rawlinson (Second Secretary), Mr Littler (Deputy Secretary) to Mr Carey (Under Secretary) whose charge now includes Accountancy, Finance and Audit Division (Mr Walker, Assistant Secretary), just transferred from CSD. The Treasury will have a particular responsibility for defining requirements, for example in computer audit, and for driving the programme forward.
- (2) The CSD will help, particularly on matters of training, recruitment and pay.
- (3) Departments (on whom the main responsibility for good management falls) are asked to agree



with the Treasury:

- by 30 September the objectives of their internal audit
 - plus the job description of the head of the unit
 - plus proposals for filling it;
- by 30 June 1982 the composition of their units, if only provisionally;
- by 31 December 1981 a course of action to bring computer audit up to scratch in three years.

POINTS FOR THE PRIME MINISTER TO MAKE

7. I suggest that the Prime Minister might make these points:

- (1) Picture painted by the C&AG not wholly black. But dark enough to be very worrying. Ministers must be able to rely on Permanent Secretaries to ensure that all their management arrangements, not just internal audit, are beyond reproach. But internal audit specially sensitive where it is a matter of money going astray: that is bad in itself but it also makes for lack of confidence in government management as a whole.
- (2) Therefore very disappointed to learn that Treasury and CSD accept as valid the C&AG's criticisms, meaning that systematic abuse would probably go undetected.



(3) But all that is water under the bridge. We are now at least facing in the right direction. Accept, too, that there ^{are} genuine difficulties. Computer audit is a new science, outside as well as inside Government. And good accountants have not been easy to recruit.


(4) Have two main interests here. First, see internal audit as just one part of good financial and resource management. Do not want to get it out of perspective. Would therefore like a free-ranging report on where we now stand on improving management as a whole in the light of Rayner "lasting reforms", eg the management job of Permanent Secretaries, training of Principal Finance Officers. Look to Sir D Rayner to supply this.

(5) Secondly, on internal audit itself, the question is, how fast and determined will the new departure be? Would like the following:

- A particular Treasury official to be designated as leader of the exercise and to report via the Chancellor during the summer on progress made. What would be the right experience and qualifications of this officer?
- The programme should be driven forward with determination. Is the timetable in the joint letter appropriate for this?

[NB I understand that the determination is there at working levels and that Principal Finance Officers in general want to make progress. The Treasury is

now engaged in devising a programme of work. The timetable looks leisurely, but I understand that the Treasury is encouraging departments to get on without waiting for the target dates noted above.]

-  What about using a firm of professional accountants with the appropriate expertise? Even if it is not a matter of devising one single model of internal audit for the whole government service, how about using a firm or firms in particular departments, both to help with their problems and to provide read-across?

(6) Send good wishes to AFA Division on its transfer from CSD to Treasury.

[NB This Division, consisting mainly of professional accountants, is pretty blameless. It has been doing its best for a long time, with somewhat fitful support and encouragement until comparatively recently. A word of support from the Prime Minister would be both a welcome boost for the staff concerned and helpful to their immediate superiors.]

(7) While the Treasury should not needlessly harry departments, it should monitor their progress with the reform programme. Look to Sir D Wass to put appropriate pressure on Permanent Secretary colleagues.



HEAD OF THE GOVERNMENT ACCOUNTANCY SERVICE

8. The Prime Minister may like to be reminded that she invited, some weeks ago, a joint report from Sir D Wass and Sir D Rayner on the location of the Head of this Service (known as HOTGAS). This report is in hand.

9. HOTGAS is being consulted on the programme but feels very strongly, as does Sir D Rayner, that it should be driven forward by a designated leader in the Treasury.

SP

C PRIESTLEY
10 April 1981

Encs: Background notes

Chancellor of the Exchequer's minute of 11 March
to the Prime Minister

Mr Whitmore's letter of 20 March to Mr Wiggins,
HM Treasury

Mr Wiggins's reply of 2 April, covering joint letter
from Sir I Bancroft and Sir D Wass of 20 March to
Permanent Secretaries

C&AG's report

FUNCTION, STATUS AND STATE OF INTERNAL AUDIT INCLUDING THE
C&AG's CRITICISMS

1. When a Permanent Head of Department signs the Appropriation and other Accounts which he submits to Parliament on behalf of his Minister in his capacity as "Accounting Officer" for his Department's Votes, he takes personal responsibility for their correctness.
2. The basic function of internal audit is therefore to provide a Permanent Head with a means, independent within his organisation, of assessing control systems to show whether or not they prevent fraud or misappropriation.
3. However, the wider function of internal audit is to:
 - review the administrative, accounting and other procedures operated day in-day out to ensure their efficiency
 - appraise parts of the organisation in a way which the line managers responsible for them may be unwilling or unable to do
 - help external auditors do their job more economically.
4. Permanent Heads are advised by the Treasury (1) to employ an internal audit unit and (2) on its role, staffing and working methods. But there is no statutory or mandatory requirement here. How far each Permanent Head goes has until now been left for him to decide.
5. In Government, the emphasis has so far been mainly on "regularity and propriety audit", ie on the avoidance of fraud and misappropriation. There has been a relatively slow movement into "systems-based audit", ie placing more

emphasis on systems of control and management than on checking individual transactions. The business of computer audit is new for everyone, in both Government and outside.

6. On the regularity/propriety front, Sir I Bancroft wrote to Permanent Heads in July 1980 about evidence which suggested an increase of fraud within the Civil Service, saying that cases notified for the periods 1970-80 totalled about £1.2m, some involving more than £30,000 each. He asked them to take a look at

- (1) In particular, control over travel and subsistence claims; and
- (2) the adequacy of their internal audit arrangements generally.

(In an article on Tuesday last, the TIMES recalled a fraud on the FCO by one of its bookkeepers involving £384,000 and the judge's comment that it had been made possible by lack of competent supervision.)

7. The previous Public Accounts Committee emphasised the importance of internal audit "in maintaining an effective system of financial control, particularly where large and complex schemes of financial support are involved" (Third Report 1979-80). The Chairman of the present PAC, Mr Joel Barnett, has told Sir Derek Rayner that he intends to keep a firm grip on the subject. He and his colleagues are now considering a report by the Comptroller and Auditor General which, as the Chancellor warned the Prime Minister in his minute of 11 March, has attracted adverse publicity.

8. The C&AG's broad assessment is that:

- (1) Despite much useful work and recent efforts to up-rate their performance, "the overall standard of internal audit units is substantially

below the level needed" (para. 10).

- (2) The "almost universal absence of an adequate capability to audit computer-based systems" is particularly disturbing.
- (3) No other weakness is so prevalent, but "the standard of audit varies sharply from unit to unit, and the differences of philosophy between departments are implicit in varying degrees of independence and scope allowed to internal audit".
- (4) There are other differences in staffing, professionalism and working methods, eg in the use made of the "systems-based approach" (see above).

8. The C &AG believes that "three underlying factors tend to militate generally against improvements" (paras. 11-14):

- (1) Although one or two departments have established high level audit committees to oversee internal audit, "there appears to be a fairly general failure by senior management within Departments to appreciate the potential benefits of an efficient, modern internal audit".
- (2) There is a general lack of professionalism in the approach to staffing. Of the 1,650 staff in the thirty-seven departmental units covered by the report, about 60% of all internal auditors are very junior, being Executive or Clerical Officers. Tours of duty are too short, which diminishes the incentive to be proficient, especially in computer audit as this "necessitates more intensive training over a longer

period". (As I observed in an earlier minute, the problem is thus essentially one of amateur financial controllers being advised by amateur auditors.)

- (3) There is no Service-wide career structure for internal auditors.

INTERNAL AUDIT IN PERSPECTIVE

1. Internal audit is just one part of good financial and other resource management.

2. The White Paper on The Future of the CSD said that the Government intended to "press forward vigorously with measures to improve financial control and management in Departments. These measures include:
 - more effective planning and control of the cash cost of programmes of public expenditure

 - further development of financial responsibility and accountability in line management

 - better matching of the financial information needed for the Public Expenditure Survey and Estimates with that need for management

 - the strengthening of internal audit in Departments" (Cmnd 8170, para. 27).

3. An equally important measure is ensuring that Finance Branches are staffed with "full regard to experience, in-Service training and external qualifications" (para. 31).

4. Sir Derek Rayner is shortly to take a meeting of Treasury and CSD officials on the subject of training for financial management. Other relevant work in the "lasting reforms" programme includes defining the responsibilities of Permanent Heads and top officials for good management, including those of Principal Finance Officers and line managers.

5. As Sir Anthony Rawlinson (HM Treasury) told the Public Accounts Committee on 6 April, the Treasury has set up a Financial Management Co-ordination Group to push all these measures forward and to assist Sir Derek Rayner. It consists of:

Mr J G Littler, Chairman (Deputy Secretary, HM Treasury)
Mr K J Sharp (Head of the Government Accountancy Service)
Mr J P Charkham (Under Secretary, CSD, Head of the
Management and Organisation Group)
Mr C Priestley (chief of staff to Sir Derek Rayner)

INTERNAL AUDIT IN CENTRAL GOVERNMENT

Memorandum by the Comptroller and Auditor General

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- A Results of E&AD's review of internal audit in central government
B Internal audit in four major Departments

Audit House
Victoria Embankment
London EC4

February 1981

INTERNAL AUDIT IN CENTRAL GOVERNMENT

Memorandum by the Comptroller and Auditor General

The role of internal audit

1. The Treasury's letter of appointment which is sent to each new Accounting Officer provides a full statement of his responsibilities and draws attention inter alia to his traditional duties for the safe-guarding of public funds and property and the propriety and regularity of the expenditure from those funds. The guide on Government Accounting which is issued by the Treasury for use in all Government Departments states that it is desirable that systems of control established to ensure the propriety, security, completeness and accuracy of departmental activities and transactions should be subject to objective review. The guide concludes that the Accounting Officer will normally employ an internal audit branch or section to undertake this work.
2. The guide also recognises that the internal audit section will normally assist the Accounting Officer in meeting his responsibility for ensuring that his Department's business is conducted economically and efficiently, that is, by undertaking "value for money" audit. But in this area the Accounting Officer will often also deploy other skilled staff, eg management services and staff inspection teams, which will affect the degree to which he calls upon internal audit for such assistance.
3. It may be noted that the Institute of Internal Auditors in the United Kingdom has defined internal auditing as an independent appraisal function established within an organisation to examine and evaluate its activities as a service to that organisation, with the objective of assisting members of the organisation in the effective discharge of their responsibilities.
4. In 1973 the Civil Service Department (CSD), in consultation with the Exchequer and Audit Department (E&AD) and the Treasury, issued guidance to all departments in the form of a booklet

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entitled "Internal Audit in the Civil Service". The booklet provided advice on such matters as the organisation and training of internal audit units; the audit approach and methods to be adopted; and the principles of internal control. CSD regarded an internal audit operating on the lines recommended as an essential feature of good departmental management. In 1977 CSD supplemented that guidance by issuing minimum standards for internal audit in departments. These are consistent with standards subsequently issued by the Chartered Institute of Public Finance and accountancy and the Institute of Internal Auditors. The CSD standards specify the requirements for internal audit's independence, training, unrestricted scope, limited responsibility for safeguards against fraud, and quality of management and of reporting. The salient points of CSD's guidance and standards have been embodied in the Treasury's guide on Government Accounting.

5. In signing the Appropriation and other Accounts rendered to Parliament, the Accounting Officer takes personal responsibility for the correctness of (or true and fair view exhibited by) those Accounts. He is advised by the central Departments to employ an internal audit unit to help him discharge his responsibilities: and he is given advice about the role, staffing and working methods most appropriate for such a unit. Internal audit in central government is thus an accepted concept. But the establishment of an internal audit unit is not governed by any statutory or mandatory administrative requirement, and how far each Accounting Officer goes in accepting the central Departments' advice is left to him to decide.

6. An internal audit unit will be expected to earn its keep in terms of a cost-effective contribution to financial control and the economic use and management of resources. The direct cash savings achieved by internal audit may be significant but they are not the only, or indeed the main, criterion. It has for long been found by large and complex organisations in both public and private sectors that the existence of an independent unit which reviews the administrative, accounting and other procedures which are operated day by day throughout the business is necessary to ensure that they remain efficient and

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do not become either top heavy or inadequate. The unit should also assess control systems to consider whether they provide an adequate deterrent to fraud or misappropriation. Furthermore it can be valuable in providing top management quickly with an objective appreciation of sectors of the organisation of a kind which cannot be obtained from line management. Finally, an efficient internal audit can and should enable external audit to perform its work more economically. Some or all of these factors also apply to smaller organisations, and the provision of internal audit support to smaller Government departments and non-departmental bodies is one of the matters dealt with below.

The relationship between external and internal audit

7. The statutory role of the C&AG as external auditor in central government is to provide an independent assurance for Parliament regarding the accuracy of the accounts prepared by departments, and on the regularity of expenditure recorded therein. The C&AG is required to report to Parliament on his audit. In giving his audit opinion on accounts he takes note of work done to an acceptable standard by the internal auditor, and normally designs his audit work to avoid duplication of the work carried out by the latter. The basic difference between the two audit roles is that the external auditor reports to Parliament whereas the internal auditor reports to the Accounting Officer. But given the measure of independence properly accorded to internal audit within Departments it is entirely right and economic for E&AD to determine its own work programme in the light of its assessment of the adequacy of standards of internal audit and knowledge of its work.

E&AD review of internal audit

8. Internal audit units at present exist in 43 departments, including all the major departments. During 1980 my officers undertook a broad review of all the units in major departments and a number of those in smaller departments and non-departmental bodies. This aimed to provide an initial analysis of performance

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by different units on a uniform basis. The review covered 34 organisations, with annual transactions, (expenditure plus receipts) totalling in excess of £130,000 million; total staff, including military personnel, of about 1,180,000; and internal audit staff totalling about 1,650 in 37 internal audit units. This represented more than 95 per cent of internal audit activity in government departments, though excluding the Department of Energy because internal audit there has been under separate examination in pursuance of PAC's recommendation in their Third Report of Session 1979-80.

(i) General findings

9. In Appendix A I summarise the general results of the review by reference to the generally accepted main ingredients of a fully effective internal audit, and in Appendix B I give brief details about four internal audit units to illustrate the present stage of development of internal audit. I emphasise that the four units in Appendix B are mentioned purely for illustration, and not because they are notably better or worse than others.

10. My broad assessment of the results is that, although much useful work is undertaken, and despite recent efforts in many Departments with CSD guidance and encouragement to improve their performance, the overall standard of internal audit units is substantially below the level needed to fulfil the role recommended by the CSD and Treasury. A particularly disturbing feature is the almost universal absence of an adequate capability to audit computer-based systems (see below). No other weakness is so prevalent, but virtually all units show other specific shortcomings which limit their effectiveness. As indicated by the factors itemised in Appendix A, the standard of audit varies sharply from unit to unit, and differences of philosophy between departments are implicit in the varying degree of independence and scope allowed to internal audit. Other differences exist in staffing, professionalism and working methods; for example, in the use made of the systems-bases approach.

11. In my view, three underlying factors tend to militate generally against improvements.

12. First, there appears to be a fairly general failure by senior management within Departments to appreciate the potential benefits of an efficient, modern internal audit providing the accounting Officer with the full range of assistance referred to in paragraph 1 above. In this context, however, I welcome the establishment by one or two departments of high-level audit committees to oversee internal audit activity: this implies an encouraging recognition of the important contribution which internal audit can make and I hope the practice will be followed widely.

13. The second point is the approach to staffing. There is a general lack of professionalism. About 60 per cent of all internal auditors in departments are Executive Officer or Clerical grade staff. Both these and staff in higher grades are assigned to tours of duty in internal audit work, in many cases 3 years or less - too short a time to become adequately trained and effective auditors before they are transferred to non-audit duties elsewhere in their departments. This factor impedes the use of modern audit methods. Moreover, staff who know they are likely to move out of audit will have less incentive to become proficient auditors. The rapid turnover is of special relevance to computer audit because the nature of that work necessitates more intensive training over a longer period, and existing arrangements have seriously impeded units' efforts to train their own computer auditors to an effective level.

14. Third, responsibility for the duties, structure and staffing of internal audit units rests mainly with individual departments; and there is no service-wide career structure for internal auditors. It seems questionable whether the needs of individual departments are sufficiently different, or their knowledge of audit methods sufficiently great, to justify this fragmented approach. And, despite the guidance available from the CSD, and the experience and knowledge which individual Departments have in their own fields, it is now extremely

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difficult for them to provide and maintain the increasing expertise they require for fully effective internal audit work.

(ii) Audit of computer based systems

15. The rapid pace of computerisation, and of technological developments in the computing field, poses new and challenging questions to all auditors. In central government most major accounting systems are now computer based, and purely manual systems of any great significance will soon be a thing of the past. The capability to undertake computer audit is therefore absolutely essential for effective internal audit of most Departments.

16. Moreover, the complexity and scale of, and potential risks involved in, computer operations are such that the auditor needs to be involved from the start in the development of all new computer applications if he is not to risk being left stranded by a system which he does not understand and cannot examine. Thus, E&AD has found it necessary to establish and, in recent years, considerably expand a specialist computer group equipped with the skills needed to evaluate computer installations and systems and to develop and operate computer audit software.

17. During 1979 and 1980, as part of a wider examination of computer installations and systems in departments, the E&AD computer group reviewed the performance of internal audit on computer systems audit. In 29 cases where it was possible to reach conclusions as to the general standard in the department as a whole, the group found that computer audit was non-existent or poor in 20 cases, of variable quality in 8 cases and quite good in one case only. Several departments were taking action to improve the position, but the group concluded that there were insufficient trained computer auditors in internal audit, that the frequency of staff changes often frustrated plans for improvement, and that it was unlikely that an acceptable level of computer audit would be attained while staff spent only a limited period in internal audit.

18. These conclusions are wholly consistent with the results of two studies in selected departments which CSD completed during 1980. CSD found that an unduly low proportion of internal audit effort was devoted to computers, and that training fell so far short of needs that there were few if any internal auditors equipped to undertake an effective audit of computer based systems. Not surprisingly, they concluded that the general standard of computer audit was poor.

(iii) Small organisations

19. There are 28 small departments where Accounting Officers are responsible for Appropriation Accounts but have no internal audit unit. These departments have total annual voted transactions in excess of £450 million, and some of them also deal with trust funds or other non-voted moneys. Similarly, some small non-departmental central government bodies have no internal audit. While the scale and nature of these organisations' transactions may make them more straightforward to audit, there can be a relatively higher degree of risk because small organisations cannot so easily achieve effective accounting controls based on separation of duties, nor do they always command a very high standard of accounting expertise. These problems and dangers become even more acute with the continuing spread of computerisation of accounting systems.

Conclusions

20. The main questions raised by this review appear to be:

(i) Is the important role for internal audit which is set out in the guidance given by the Treasury and CSD generally accepted?

(ii) Is it agreed that substantial changes are essential if internal audit is to play that role effectively throughout central government?

(iii) Would some of the necessary action be best tackled on a centralised Service-wide basis?

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- (iv) What are the main priorities for action by individual Departments?
- (v) What are the implications for the relationship between internal audit units and E&AD?

21. On the role of internal audit, all major Departments clearly accept in principle the suggestion by the Treasury and CSD that Accounting Officers should arrange for objective review of their systems of financial control, etc, and have set up internal audit units. But setting up the unit is only the first step. It does not appear to be generally appreciated that for the unit to be effective it needs to use modern methods and techniques and to apply them over the whole field (paragraph 1 above). Accordingly internal audit should not be regarded as an optional extra or as a lower level of audit activity. It should be treated as an essential departmental requirement; be applied to the full range of financial activities - though in a structured manner having regard to risk and materiality; and be managed and to a significant extent conducted by staff as well qualified as external audit staff.

22. It must be emphasised that there is a world of difference between the mechanical or half-informed application of routine audit processes, and skilled auditing by well-trained staff who adopt the systematic but flexible approach with which modern methods are intended to be used, and who can apply experienced audit judgement to their findings. A mechanical audit, systems based or otherwise, is not a near-substitute for such work. If, at the extreme, it were to waste the time of both management and audit staff, and give an unjustified feeling of assurance that all was well, it would be worse than useless.

23. On the need for substantial change, there seems to be very little room for doubt. This conclusion is supported by the attention already being devoted to the subject in a number of Departments, though not always in those where this review

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indicates the greatest need for change. The nature and scale of change needed appears to vary somewhat from one Department to another. It is not possible on the basis of this review to provide an overall estimate of the desirable changes in the numbers and gradings of staff. The dominant impression, however, is of a need for a greater proportion of more professional, highly graded, staff, but not necessarily for larger numbers overall.

24. On centralised, Service-wide action, there is scope for extension of the role hitherto played by the CSD both in issuing general guidance and through training provided at the Civil Service College. In February 1981 the Government announced in Cmnd. 8170 that they agreed with the Treasury and Civil Service Department Committee's suggestion that CSD's Accountancy, Finance and Audit Division should be transferred to the Treasury, and that they intended to press forward vigorously with measures to improve financial control and management in departments, including the strengthening of internal audit. If substantial changes are to be achieved across the Service, Departments will expect and require some vigorous central co-ordination; it is here that the Treasury and CSD will wish to consider with Departments how this should be developed. For the objective goes beyond a straightforward expansion of numbers of staff in order to increase the volume of routine checks on transactions or on systems of control: it is a more sophisticated process of improving efficiency and cost-effectiveness in audit work by the application of modern systems-based audit methods which are constantly developing and are not widely understood outside the auditing profession.

25. There would seem to be a particularly urgent need for a revised Service-wide understanding of the qualifications and training required for internal auditors. There will also be a need for the Treasury and CSD to establish criteria to assist Departments to specify the work to be done by their internal audit units and to assess, at least provisionally, the numbers and grades of staff required. Until provisional decisions are taken on these matters it will hardly be possible to organise

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the necessary training or to prepare plans for the various changes which it will inevitably take several years to implement fully.

26. The need for early action on computer audit poses a special problem, again seeming to call for a co-ordinated approach and for additional training facilities. The Treasury and CSD will no doubt have this in mind in the light of their own reviews of computer audit (paragraph 18 above).

27. But it is questionable whether an extension of CSD's traditional role on guidance and training is all that should be undertaken centrally. There is clearly a case to consider for the establishment of a Service-wide cadre of internal auditors, who would be subject to centralised professional oversight. The main objectives would be to enable each Department to obtain an adequate number of fully trained staff; to secure the maintenance of a high level of professional standards; and to provide a career structure in internal audit which would facilitate the recruitment and retention of suitable staff. Individual Departments would no doubt also wish to include in their internal audit units other staff from their own departmental sources who, after training, would be assigned for tours of duty and then return to non-audit work.

28. The establishment of a Service-wide cadre of internal auditors could make a major contribution towards the particular problem of improving computer audit. For it would provide the conditions under which those staff could remain on audit work long enough to acquire and use the necessary skills and knowledge; and for those with the right aptitude to specialise and become expert and, over a period, gain wide experience at a variety of computer installations. Such strengthening of Departmental internal audit units might need to be complemented by the establishment in the Treasury of a small central corps of computer audit experts to provide training and advice and carry out special assignments. But computer audit should not be entirely hived off from the Departmental units and undertaken centrally: the objective should be to create arrangements under

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which the bulk of computer audit is undertaken as an integral part of the work of the Departmental units.

29. As for those Departments and other bodies who consider themselves too small to set up their own internal audit units (paragraph 19 above), it should be possible to establish in the Treasury a central internal audit unit to provide not only this service but also the additional accounting expertise which some of them lack.

30. The main priorities for action by individual Departments will have to be considered by Departments themselves in the light of their particular circumstances. I would offer the following general comments:

- (a) The Accounting Officer and his Principal Finance Officer (or equivalent) should provide, and be seen to provide, active support for internal audit units. The status of these units and the impact of their work depend critically on that support. The establishment of high-level audit committees to oversee their work and periodically to consider their results is well worth consideration. On the other hand, "raiding" them when staff is temporarily short elsewhere in the Department not only indicates that a low value is placed on their work but is inimical to the necessary development of highly skilled auditing.
- (b) Most of the possible central developments mentioned in the previous paragraphs will take time to mature: some may require lengthy consultation before decisions are taken. Action by individual Departments should have regard to these possibilities but cannot wait for them to be dealt with first. A number of Departments have recently reviewed their own internal audit units; others might usefully do so in the light of this Memorandum and against the standards and guidance which CSD have already issued, with the objectives of specifying the work to be done by the units and assessing the staffing needs. E&AD would be willing to assist in this process.

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- (c) Changed attitudes to staffing these units could be implemented without delay. Staff should be selected carefully, taking account of aptitude and potential for a more professional approach to audit work in the future. Even those not seeking a career in internal audit should expect to remain on audit work long enough to be adequately trained and to operate as fully experienced and effective auditors. The period could vary, but anything less than 4 or 5 years is unlikely to be worthwhile. Promotion on internal audit work should be possible.
- (d) As is emphasised throughout this Memorandum, modern accounting systems and audit methods demand a high degree of expertise in the auditor. A marked change of emphasis towards the employment of high quality staff is therefore essential; and increased attention should be paid to training.
- (e) In many units, the method of auditing needs revision. Too much emphasis tends to be placed on routine checking of transactions and too little on the evaluation and testing of systems of control. In practice, however, a suitable and properly structured systems-based approach is unlikely to be devised and introduced successfully unless expert guidance is obtained.

31. The formal relationship between internal audit and E&AD will not be affected by changes to improve the effectiveness of internal audit. As remarked in paragraph 7 above, their responsibilities differ: an internal audit unit reports to the accounting Officer, the external auditor reports to Parliament. But if the internal units were staffed and conducted as envisaged in this Memorandum, and contributed to an effective evaluation of those authorisation and control systems which are material to the C&AG's audit opinion, and the assurances he has to give to Parliament, E&AD would be able to place greater reliance on them and by avoiding duplication could reduce the overall resources devoted to financial and regularity audit.

32. The opportunities for fruitful cooperation should also be enhanced. This is desirable and I believe acceptable between E&AD and the central Departments on general aspects of audit approach, method and training; and between E&AD and internal audit units on the operational planning of audit work and on its detailed execution in individual Departments. Good working relationships exist at present, and there is already a fair degree of useful cooperation. A greater similarity in the staffing and general approach to financial and regularity audit should make close cooperation possible on a much wider basis and enable the objectives of internal and external audit to be met more fully and more cost-effectively in the future. I would welcome similarly increased cooperation on the value for money work undertaken by E&AD and internal audit units, notwithstanding the need for the C&AG to report on certain matters to Parliament.

Summary

33. In this Memorandum, I have recorded the results of the review carried out by E&AD in 1980 and my conclusion that the overall standard of internal audit units is substantially below the level needed to fulfil the role recommended by the CSD and Treasury. I have suggested a package of remedial measures for consideration. The key points are general recognition of the potential role of internal audit and new staffing arrangements for the units. Progress on these would clear the way for general improvements. But without such progress, I consider that the underlying problems will continue to detract from the effectiveness of internal audit.

Exchequer and Audit Department
February 1981

APPENDIX A

RESULTS OF E&AD'S REVIEW OF INTERNAL AUDIT
IN CENTRAL GOVERNMENT

The results of the E&AD review of internal audit are presented under 7 headings, and indicate the more significant points on which actual performance was found to deviate from the CSD's or other generally recognised standards for internal audit.

(A) INDEPENDENCE AND STATUS

- (1) A few internal audit units were located in Accounts Branches, or otherwise subject to management direction or restriction. Over one-quarter of the units had non-audit responsibilities which detracted from their effectiveness on audit.
- (2) The majority of heads of internal audit were of Principal or lower grade, whereas line division heads were usually of Assistant Secretary grade. This relatively low status reduced the impact of their reports unless internal audit was seen to have the full and enthusiastic backing of the Accounting Officer and his Principal Finance Officer.

(B) SCOPE

- (3) about one-quarter of the units examined did not cover all of their organisations' financial activities, and the responsibilities of a similar number were not defined in writing.
- (4) About half the units did not give the Accounting Officer specific assurances before he signed formal Accounts for rendition to the C&AG.

(C) STAFFING

- (5) Internal audit staff numbers vary considerably in relation to the scale of different departments' financial transactions. These variations reflect factors such as the nature and complexity of the Departments' transactions and geographical organisation and the extent to which they fund outside bodies subject to other forms of audit. There appear nevertheless to be some inconsistencies in staffing levels.
- (6) Internal audit staff were heavily concentrated (over 60 per cent) in the Executive Officer (EO) or clerical grades; these grades undertook the bulk of the basic audit work. By contrast, E&AD has found that the bulk of such work needs to be undertaken by staff of higher Executive Officer or Senior Executive Officer grading and calibre.
- (7) Postings to internal audit were usually part of general career patterns. Tours of duty were frequently less than 3 years, too short a time to become adequately trained and effective auditors.

(D) TRAINING

- (8) Only about 2 per cent of central government internal auditors were professionally qualified: many units had no professionals at all.
- (9) Nearly all units made use of CSD's basic training courses for internal auditors. However these courses were of short duration and limited depth and were not intended as a substitute for professional qualifications.
- (10) Few internal auditors had training adequate to enable them to undertake the audit of computer installations and systems.

(E) PLANNING

- (11) About half the units examined had no long-term plan to ensure that all areas subject to audit were covered in a defined period.
- (12) The overall quality of planning varied widely, and in about half the units it did not indicate relative priorities and risk areas.

(F) AUDIT OPERATIONS

- (13) In about one-third of the units the work was based on examination of individual transactions rather than primarily on systems: many units made little or no use of aids to audit such as flowcharting, ICQs and statistical sampling.
- (14) The quality and maintenance of audit programmes and standing files varied considerably; there was therefore a risk that staff, especially those with limited training or experience, did not spend their time to best advantage.

INTERNAL AUDIT IN FOUR MAJOR DEPARTMENTS

Appendices B(1)-(4) give some brief details about internal audit in 4 departments:

- B(1) - Ministry of Agriculture, Fisheries and Food
- B(2) - Department of Education and Science
- B(3) - Home Office
- B(4) - Property Services Agency (Department of the Environment)

Between them, these illustrate most of the points listed in appendix A and show that they do not apply equally to all units. These examples are intended to be illustrative; they do not signify that internal audit is necessarily more or less effective in these 4 departments than in central government generally, nor are they presented as complete evaluations.

The structure and responsibilities of the 4 departments, and the scope of their internal audit units, vary considerably. For these reasons, the apparent variations between their audit staff numbers in relation to the values of payments/receipts do not necessarily indicate significant differences in standards of audit. It should also be noted that in addition to internal audit, the Departments also employ staff on management services and staff inspection duties which may affect the extent to which the Accounting Officers call on internal audit for assistance in ensuring that departmental business is conducted economically and efficiently.

- (15) Although about half the units examined made some use of computer interrogation, over half accepted that they could not cover computer based systems effectively.

(G) PROGRESS MONITORING, REVIEW AND REPORTS

- (16) About one-third of the units did not systematically monitor progress of audit work.
- (17) In a few cases, senior officers did not review audit work to assess the validity of conclusions; in other cases, review did not always cover the supporting documentation.
- (18) A few organisations did not require their line managers to reply in writing to all internal audit reports, and some units did not invariably pursue their reports to determine whether satisfactory action had been taken.
- (19) A few units did not report regularly to the Accounting Officer or the Principal Finance Officer on the results of their work, and a larger number did not have periodic meetings with the AO, PFO or senior line managers.
- (20) In about half the organisations examined it was not the practice for internal audit representatives to attend meetings held to plan and progress changes in systems of internal control.

Ministry of Agriculture, Fisheries and Food

Payments and receipts total about £580 million.

The internal audit unit is headed by an Assistant Secretary, who reports to the Principal Finance Officer but has a right of direct access to the Accounting Officer. The audit branches are free from management restriction. A separate branch within the unit undertakes costings and management accountancy but has no audit duties.

In September 1980 the unit's staff complement was 188 and the numbers in post were 156, of whom 74 were EOs and 28 were of lower grades. Following a recent staff inspection the unit is moving towards a complement of 160 including 80 EOs and 24 lower grade staff. Of these about 27 are employed in the costings branch, and the equivalent of 33 staff undertake audit and verification work on behalf of the Intervention Board for Agricultural Produce. As a result the staff in post engaged on audit of the Ministry headquarters and regional organisations and of its associated non-departmental bodies (to which there is an appropriate degree of access) was 96. This number may fall further as a result of the departmental-wide manpower economies which the Ministry is required to achieve during the next 3 years. Tours of duty average upwards of 5 years. The unit contains a number of professional accountants (16 in September 1980), but has difficulty in recruiting and retaining them.

In the past, the unit has not operated standard planning procedures to control the audit work, but it is currently adopting a more consistent basis. Similarly, the unit has previously based much of its audit on examination of a standard proportion of transactions, but is now adopting the systems based approach. The unit submits an annual report to the Principal Finance Officer and examines formal Accounts to be rendered to the C&AG.

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All of MAFF's transactions are brought to account through a computerised system. Internal audit use the computer to select transactions for their audit tests and they have started to evaluate the computerised processes. The unit is taking steps to improve its computer audit expertise, including a three-months training attachment of one member of its staff to E&AD's Computer Group.

Department of Education and Science

Receipts and payments total about £3,420 million (including those of the Office of Arts and Libraries).

The internal audit unit has 10 staff, headed by a Senior Principal (part-time). The unit has a full-time Principal with audit experience who is supported by a part-time SEO, 3 HEOs and 4EOs. The two part-time staff have other responsibilities relating to matters which are subject to audit examination, while the remainder of the unit is concerned solely with internal audit duties. The unit also calls on the services of the Department's professional accountants. Its terms of reference are clearly defined and it generally operates independently. It does not report on formal accounts to be signed by the Accounting Officer and rendered to the C&AG.

The Votes for which the DES and OAL are responsible include payments to 7 bodies with their own Accounting Officers for the grant in aid account. Apart from universities where, by convention agreed by PAC, the DES Accounting Officer need not normally be involved, the grant-aided bodies employ about another 25 internal auditors. For some of these bodies DES internal audit has only limited access.

Before 1980 the unit's audit work was transactions-based. In preparation for a change in approach an interim programme of work gave priority to those accounts involving large payments, frequent transactions or problems of control where the risks were thought likely to be the greatest. The programme was approved in advance, reports were issued on each audit and a summary of progress was included in the unit's annual report. In June 1980 the unit introduced a systems-based approach and the audit assignments have been selected with regard to a detailed analysis of risk. The unit is also seeking to establish detailed planning of each assignment against which progress

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can be monitored. At the time of surveying the audit field the unit estimated that with existing resources it would take over 3½ years to deal with the Department's own accounts (excluding visits to grant-aided bodies), and they intended to develop a long range plan to cover the most critical areas on a cyclical basis.

DES operates large scale computerised accounting systems, but the internal audit unit contains no fully trained computer auditors and has not been able to cover these areas adequately. An officer with computer experience has recently been appointed to help deal with this aspect.

Home Office

Payments and receipts total about £1,860 million. (This figure includes some £140 million audited by the internal audit unit of the Lord Chancellor's Department on behalf of the Home Office).

The internal audit unit is headed by a Principal and forms part of the Accounts Branch, where it sometimes undertakes work on behalf of line management. In 1979-80 the staff complement was 34, but the actual numbers in post averaged only 22, including 18 of EO or lower grade. The complement has since been reduced to 29, but with a higher proportion of grades above EO. The unit includes no professional accountants. The average tour of duty has been about 3 years. The unit does not examine the whole range of the Home Office's financial activities, and does not report on formal accounts.

Examination is not systems-based, resources being applied mainly to checking of transactions arising at outstations such as prisons. The unit contains no trained computer auditors and although it has made a contribution on at least one developing system it does not have the expertise or resources to cover the Department's full range of computerised accounting systems.

The above position is in the course of change. At the Home Office's invitation, CSD examined the internal audit arrangements in the Home Office during 1978-79 and in a report at the end of 1979 recommended significant changes. These include:

- The internal audit unit to be organised as an independent entity, separate from the Accounts Branch.
- Internal audit's scope to extend to all financial matters.

- Establishment of a section to specialise in computer audit, headed by an "appropriately qualified" SEO.
- Chief Internal Auditor and two other staff to be professional accountants.
- More emphasis on systems-based audit.

Most of these and other recommendations have been accepted by the Home Office. A number of substantial changes in line with the report have already been made and other recommendations will be implemented as the necessary staff can be recruited and trained. This will inevitably be a gradual process.

Property Services Agency (Department of the Environment),
excluding PSA Supplies

Receipts and payments total about £1,750 million, including some payrolls for other departments.

In November 1979 the internal audit unit was separated from the Accounts Division following a recommendation of the PSA Management Review Steering Committee. Under the new arrangements, the unit comes within PSA's Professional Accountants Unit (PAU); the Director Accountant in charge of the PAU is the Head of internal audit and he reports to the Principal Finance Officer, with the right of direct access to the Accounting Officer.

The unit's staff (excluding staff on Supplies audit) averaged about 65 in 1980, including 35 EOs and 4 COs. The Head of internal audit and two of his senior staff are professional accountants. The unit's responsibilities extend to all relevant PSA financial activities, and it operates independently of management, but it does not report on formal accounts. A high-level Internal Audit Committee, chaired by the Principal Finance Officer, reviews the unit's work regularly.

The unit bases its work on annual and long-term audit plans. Much of the work is becoming systems-based, making use of modern techniques including flowcharting and statistical sampling, but the unit has not yet been able to deal fully and effectively with computerised functions. PSA operates a major computer installation at Hastings, which processes a high proportion of its financial transactions and deals with a variety of large-scale accounting functions, but the unit's computer audit has suffered from staff shortages and lack of expertise, and it had experienced some difficulty in obtaining places on specialised training courses. As a result, up to the beginning of 1980 the unit had carried out no systems audit on the main Vote accounting function for more than 4 years. The only previous review, in 1975, had not been fully documented. The unit has made some progress in the use of computer interrogation

A joint PSA/Treasury review of the internal audit function
in PSA is due to start in April 1981.