

Leeds City Council
Review of Internal Audit

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KPMG LLP

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1 Executive Summary

1.1 Introduction

An effective Internal Audit (IA) function is required to deliver a quality, independent and objective opinion on the control environment, risk management and corporate governance to the organisation it serves. *The CIPFA Code of Practice for Internal Audit in Local Government in the United Kingdom 2003* defines the way in which the internal audit service should be established and undertakes its functions. Leeds City Council assisted in the development of the Code which provides the framework for assessment of the IA function in Leeds.

1.2 Key findings

We concluded that the Authority's IA arrangements are satisfactory and include many aspects of good practice such as:

- a highly qualified team reflecting the skills required to satisfy the demands placed upon the IA function at the Authority and the auditing profession more widely;
- a well derived and continually updated risk based operational plan which recognises the key risks to the authority and plans resource allocation accordingly;
- a thorough staff appraisal system encompassing technical and non technical competences;
- a well developed and comprehensive training manual which has received CIPFA accreditation;
- substantial investment in the Galileo budgeting and time monitoring system which will be fundamental in future staff planning;

- effective planning has helped identify the shortage of resources within the IA function when considered against the staff plan for 2005/06 and flexible working practices detailed in section 4.3 require continuing implementation; and
- core competences which have been developed and applied within the IA function's staff appraisal system would be relevant to other professional departments within the Authority and could serve as a model of best practice.

1.3 Key learning points

To improve the performance of the IA function there is a need to periodically evaluate the effectiveness of arrangements at the Authority. Through consideration against the Code of Practice the following key learning points were noted:

- greater weighting should be given to customer satisfaction questionnaires and the role that they can play in staff training and development;
- consideration should be given to formally recognising the importance of satisfying CPD requirements in the staff appraisal framework; and
- the output from the Galileo work management system should be integrated within the development of the operational plan and evaluation of contingency arrangements.

1.4 The way forward

We will discuss the findings of this review with officers to agree an action plan to address the key issues.

2 Introduction

2.1 Background

Internal Audit (IA) is part of the Corporate Services Department and is an assurance function that primarily provides an independent and objective opinion to the organisation on the control environment comprising risk management, control and governance by evaluating its effectiveness in achieving the organisation's objectives. It objectively examines, evaluates and reports on the adequacy of the control environment as a contribution to the proper, economic, efficient and effective use of resources.

2.2 Scope and Objectives

Our report follows up the recommendations from the Audit Commission's earlier report (section 3) and focuses on CIPFA's *Code of Practice for Internal Audit in Local Government* in respect of staffing, training and development (section 4) and audit strategy (section 5).

The standard on staffing, training and development is important as it helps determine whether IA is appropriately staffed in terms of numbers, grades, qualification levels and experience, having regard to its objectives and required standards.

The standard on audit strategy is important as it specifies the need for a high level statement of how the internal audit service will be delivered and developed.

2.3 Audit Approach

We have undertaken our review based on the standards mentioned above as well as identifying progress on recommendations raised by the Audit Commission in 2003/04.

Our approach has been to:

- discuss and review evidence to support progress on previous recommendations;
- review the audit planning process including the risk methodology and the application of results;
- review current and future audit plans; and
- review staffing levels and mix.

2.4 Acknowledgments

We would like to take the opportunity to thank all the officers who supported this study, and specifically Neil Hunter and Kathryn Phillips who were the primary contacts during the course of the work.

3 Follow up of Audit Commission's Recommendations 2003/04

3.1 Introduction

As part of the 2003/04 audit plan for the Authority a thorough review of the IA function was completed. This was conducted in order to meet the requirements of the Statement of Auditing Standard (SAS) 500.3 issued by the Auditing Practices Board, requiring external auditors to perform an annual evaluation of the Internal Audit function and to meet the Audit Commission's *Code of Audit Practice* responsibilities.

3.2 Audit Approach 2003/04

The Audit Commission's approach in 2003/04 was to carry out an evaluation assessing the extent to which the IA function complied with the CIPFA *Code of Practice*. The Audit Commission undertook a structured review which covered the following areas:

- objectives and scope;
- independence;
- staffing and training;
- relationships;
- due care;
- planning, controlling and recording;
- evaluation of the internal control system;

- evidence; and
- reporting.

The Authority's IA function was given compliance rating of **satisfactory** in *Planning, Controlling and Recording* as well as *Reporting* and rated as **excellent** in *Relationships*. In total 15 recommendations were made by the Audit Commission and responses were provided by the Head of Internal Audit and Chief Officer (Audit and Risk) in the action plan developed in reaction to the findings. The implementation of measures to address these recommendations was reviewed and found to be satisfactory with the exception items detailed specifically in section 3.3.

3.3 2003/04 Audit Commission Recommendations Outstanding in 2004/05

A recommendation was made regarding the non-return of audit satisfaction questionnaires. The Audit Commission found that there were inadequate arrangements for identifying and following up questionnaires issued. At the time the Audit Commission's report was drafted, IA stated that this was not an efficient use of resources.

The Authority reports that for 2004/05, 90% of questionnaires **returned** scored 'good' or 'excellent' when questioned if the audit was constructive and added value overall. IA's weekly performance report for the week ended 31 March 2005 showed that in year, of the 203 reports completed approximately 63, 31% of customer satisfaction questionnaires had been returned. This is seen as a positive result given that the Authority is ahead of many core cities in implementing such a system. However, improving the return rate would aid the function in two ways:

- the performance information within IA's Annual Audit Report would be more representative of the work undertaken in year; and

- as the questionnaires cover a number of technical areas such as 'understanding of systems' and 'accuracy of draft report' which are fed periodically into the Audit Management Team meetings and aid the identification of training needs, a greater return rate would improve management information and training decisions.

The recently implemented Galileo time recording system has the ability to generate customer satisfaction questionnaires for each assignment undertaken and should ease the administrative burden of issuing and following up customer satisfaction questionnaires.

Recommendation 1

The Authority should use Galileo as a tool to generate and track customer satisfaction questionnaires with the aim of improving the return rate. A greater return rate will improve management's performance information and aid in the assessment of training needs.

4 Staffing, Training and Development

4.1 Introduction

The CIPFA *Code of Practice* states that IA should be appropriately staffed in terms of numbers, grades, qualification levels and experience, having regard to its objectives and to these standards. Internal auditors should be properly trained to fulfil their responsibilities and should maintain their professional competence through an appropriate ongoing development programme.

4.2 Staffing Structure

An organisation chart of the current staffing structure can be seen as appendix 2. At present, and as commented on in the Audit Commission's report, the Authority's IA function is highly qualified. The function stands at 25 FTE staff. Of the 25 staff current employed:

- 14 are CCAB qualified
- 4 are AAT qualified
- 1 are IIA qualified
- 6 IIA trainees

As the function is comparatively highly qualified, the expectation is that the gross cost per net chargeable day would be far higher than other core cities IA functions. The Authority has been monitoring relative performance through an agreed series of performance indicators and when compared with other core cities the cost per net chargeable day in 2004/05 of £243 marginally is below the average reported cost of £246. Another indicator reported which gives an approximate indication of the level of experience within an internal audit function is the number of IA days per £1m Net Revenue Charge (NRC) and Housing Revenue Account (HRA). As expected, the outturn for this indicator for 2004/05 reflects the level of experience of the team with Leeds reporting 6.53 IA days per £1m NRC and HRA against an average of 7.51 days.

When these two indicators are considered together it appears that the IA function at Leeds is performing efficiently and effectively against other core cities. The primary force driving the need for highly qualified team at the Authority is delivery of a challenging annual internal audit plan and the skills needed to conduct meaningful ad hoc investigations.

The Audit Commission observed that Leeds were performing at the median in terms of qualitative performance indicators and advised that development plans be developed so that this aspect of IA performance is continually improved. Customer satisfaction questionnaires are a primary source of information in evaluating qualitative performance and as detailed in section 3.2, the recommendation that customer satisfaction questionnaires are followed up by internal audit was rejected in 2003/04 as an inefficient use of IA resource.

IA have highlighted the importance of the comparison with other core cities in terms of the quality of the output in the *Audit and Risk Division Plan 2005/06*. The integrity of this information is contingent upon a representative return of customer satisfaction questionnaires. The use of Galileo to aid management of the customer satisfaction questionnaire system, as recommended, should improve qualitative performance information.

4.3 Staffing levels

As detailed in section 4.2 the IA function has 25 FTE staff. The level and mix of staffing is governed by the audit risk assessment which determines the strategic plan for the year ahead. The skills mix also reflects increased technical demands in the auditing profession generally through the introduction of International Auditing and Financial Reporting Standards (IAS and IFRS), greater emphasis on fraud and a shift towards more proactive rather than reactive work. This is examined in more detail in section 5. The technical manual developed by internal audit correctly states that due to IA facing 'continuing change in working methods, for example a greater push towards e-government, and is responding to modernising political structures' there is a need for the Head of the IA function to continually consider the staffing strategy.

Flexibility of staffing arrangements and a mix of specialist skills are cited as key in delivering IA's strategic plan. This has been achieved in Leeds through the following measures:

- four agency staff (three of which are CCAB qualified) have been employed to cover peak work flows;
- part-time and term time working has been enabled;
- secondments; and
- partnership working with other internal audit sections and the private sector.

However, a review of the operational plan to 31 March 2005 showed that against the plan for 2004/05 there was a shortfall of 756.3 days which equates to completion of 91% of the annual plan. This was primarily caused by 'a significant number of assignments and projects undertaken by IA during 2004/05 which were not included in the 2004/05 operational plan staffed using contingency allocation' and two staff members (Senior Audit Manager and Audit Manager) being on secondment in year. The number of days included as a contingency has since been increased as detailed in section 5.4.

Ad hoc members' referrals have formed a substantial part of the additional work not foreseen in the plan. The following were material in terms of audit days:

- Passenger Transport Executive fraud investigation 201 days;
- An investigation into the over-spend on the Carriageworks capital project 50 days;
- Abbey and St Ann's Mills investigation 21 days; and
- South Leeds Stadium review 21 days.

To a far lesser extent, involvement in the provision of internal audit services to Leeds West Homes and Leeds North East Homes has also eroded the time available to the IA function in 2004/05. However, such fee generating work enabled IA to employ agency staff to cover any displacement of permanent staff. Again, qualitative indicators should be used to ensure that short term agency staff perform to the levels expected of permanent staff including measures such as customer satisfaction questionnaires. The shortfall was also due to the loss of time on unproductive jobs and small overspends on planned audits. The introduction of the Galileo time recording system should aid improvement against the operational plan for 2005/06 as management information will be more accurate and timely.

The pressure upon IA's staffing is also apparent through the timeliness of reporting. In the year ended 31 March 2005 68% of reports were completed within target. Additional capacity would aid improvement of this statistic.

Recommendation 2

Through a combination of flexible working practices and competitive salaries at the market rate IA should attract additional staff to meet any shortfall predicted in the operational plan going forward.

4.4 Staff Training and Development

IA's Service Plan for 2005/06 states that '*the Mission Statement for Internal Audit is to add value to the Authority.*' In order for IA to deliver two of the key objectives within this plan and for IA to ultimately achieve its primary aim effective staff training is paramount. These objectives are:

- IA audit remains relevant by adding value; and
- IA becomes a Centre of Excellence for new and emerging issues within the audit field.

Overall, importance of quality staff training is demonstrated through the following measures which are in place at the Authority:

- structured staff training is linked to specific training requirements identified through engagement review forms which are completed by the auditor and considered with the engagement manager as part of the appraisal system;
- customer satisfaction questionnaires and the use of the Galileo time recording system which shows budget versus actual performance feed into the framework for establishing training needs;
- staff training is linked to IA's operational plan which in turn is linked to the achievement of the Authority's corporate objectives and values;
- the potential for joint training sessions with private sector organisations is considered if these will satisfy a training need;

- a comprehensive technical competency manual for IA has been developed and adopted by CIPFA to be used in the revision of its 1994 Audit Training Planning Guide;
- IA as part of the Corporate Services Division has an Investors In People Accreditation;
- high level annual reviews of training measures in place within IA are considered annually by external audit;
- a monthly newsletter is circulated within the IA department containing a section on technical current developments which are relevant to Leeds or Local Government generally establishing a framework for disseminating emerging issues; and
- the importance of staff satisfying Continual Professional Development (CPD) requirements has been recognised.

4.6 Appraisal Framework

Due to the highly qualified make-up of the IA function at Leeds the proportion of training delivered in a formal environment such as exam training is reduced. Individuals have a duty to satisfy the member CPD requirements of their respective accountancy bodies which can be done in a number of ways which the IA function have limited control over such as attending CIPFA events, reading accounting and auditing periodicals and self study. In order for IA to satisfy its objectives in terms of emerging issues the scope for formalising CPD internally should be considered.

Recommendation 3

IA should as part of the appraisal system require individuals to detail how they have met their CPD requirements in year as part of the knowledge competency section.

5 Audit Strategy

5.1 Introduction

The audit strategy is a high-level statement of how the IA service will be delivered and developed. The Head of IA should develop and maintain a strategy for delivering the IA service as per the terms of reference.

The CIPFA *Code of Practice* states that it is important for IA to plan effectively to ensure that they contribute to the organisation's objective at strategic and operational levels. Planning also enables IA to demonstrate both internally and externally that they are making the best use of resources. Any difference between the plan and the resources available should be identified and reported to the Authority.

5.2 Planning Arrangements

The IA function at Leeds City Council prepares an annual operational plan which is based on a risk assessment of all identified assignments at the Authority and the function's external clients such as the ALMOs. Each job is scored according to the following criteria:

- materiality;
- business risk (including political sensitivity);
- audit experience;
- other assurance assessment (risk management function and self-assessment assurance);
- fraud; and
- time since last audit.

Improvements have been made to the planning process since the Audit Commission review of 2003/04. In particular, a recommendation to include political sensitivity as a separate weighting has been included in the *'Business Risks'* category which are defined as areas with non-financial but reputational impact. The IA operational plan for 2006/07 will also include a third risk indicator under *'Other Assurance Assessment'* namely *'Other External Assurance'* whereby the impact of an area of the Authority on the opinion of other external bodies such as OFSTED will be formally considered. This will ensure that where appropriate reliance will be placed on other formal review bodies to maximise the use of resources within IA and minimise duplicated work.

There are a number of areas which are not subject to risk assessment and are prioritised in the operational plan. Such areas include fundamental systems, in year priority systems, establishment visits, information technology, corporate governance, procurement and contract audit. In terms of audit days in the 2005/06 plan the above equate to 2,950 of a total 5,220 days. All remaining audit areas are subject to risk assessment and included or excluded from the operational plan according to the result. Fundamental systems are reviewed by IA each year to minimise duplication with external audit as these would be considered as part of the financial statements audit each year.

5.3 Time allocation

Each planned assignment in the operational plan is allocated an estimated number of days based on the estimated days from the previous year's plan. These estimates are reviewed and manually updated to reflect the level of anticipated work required in the coming year from knowledge of technical audit requirements. However, in order to more effectively plan resources IA should incorporate actual time taken to complete an assignment in the previous year as well as management's knowledge. The introduction of the Galileo time recording system should aid this process.

Recommendation 4

Both management knowledge of technical audit requirements and prior year's actual time to complete an audit assignment should be built into the estimated number of days to complete an assignment for future operational plans.

5.4 Contingency

Given that IA operates within and needs to react to emerging issues, a contingent element is incorporated into the operational plan. This has been increased in the 2005/06 plan to 1,435 days from a budgeted 930 days in the 2004/05 operational plan. This is a reaction to the nature of the work undertaken in 2004/05 and the level of ad hoc requests received by IA. To perform such requests effectively often requires experienced staff to exercise their professional judgement. The complex nature of work undertaken by IA has shaped the mix of staffing within internal audit as detailed in section 4.3.

Recommendation 5

The Galileo time recording system should be used as part of the formal consideration of contingency levels in the operational plan in future periods.

5.5 Formal Approval of Operational Plan

The operational plan is approved at the Authority's Corporate Governance and Audit Committee. This committee was established, in part, as a reaction to the Audit Commission's review of IA conducted in 2000/01. Approval at a strategic level of the operational plan is assured through presentation at this committee. The Committee also serves to monitor performance against the approved plan.

Formal approval and monitoring of IA's operational plan helps to ensure that the importance of the IA function in terms of achieving effectiveness, efficiency and economy in the use of the Authority's resources is recognised, fraud risk is minimised and core areas of the plan are achieved. A six-monthly report on progress against the operational plan for 2005/06 was presented to the Committee on 21 December 2005.

Appendix 1

Recommendations

| | | | | | |
|-----|----------------------|----|------------------------|---|---------------------|
| *** | <i>High priority</i> | ** | <i>Medium priority</i> | * | <i>Low priority</i> |
|-----|----------------------|----|------------------------|---|---------------------|

| Recommendation | Priority | Management response | Responsibility and timescale |
|---|----------|--|------------------------------|
| 1 The Authority should use Galileo as a tool to generate and track customer satisfaction questionnaires with the aim of improving the return rate. A greater return rate will improve management's performance information and aid in the assessment of training needs. | * | Agreed, this will be implemented in April 2006. | Alex Firth |
| 2 Through a combination of flexible working practices and competitive salaries at the market rate IA should attract additional staff to meet any shortfall predicted in the operational plan going forward. | ** | Flexible working practices are already in place and significant resource has been put into IT to further facilitate remote working. Obviously the ability to pay market rate is more problematic hence the high numbers of trainee auditors. | Neil Hunter |
| 3 IA should as part of the appraisal system require individuals to detail how they have met their CPD requirements in year as part of the knowledge competency section | ** | Agreed. CPD will continue to be a major theme during 2006. The ability to use the CLC will significantly facilitate this and discussions with CIPFA are currently ongoing. | Alex Firth |

| Recommendation | Priority | Management response | Responsibility and timescale |
|--|----------|---|------------------------------|
| 4 Both management knowledge of technical audit requirements and prior year's actual time to complete an audit assignment should be built into the estimated number of days to complete an assignment for future operational plans. | ✱ | This will continue to be achieved through the Risk Maps at the completion of each audit assignment. However, Galileo will further improve this procedure as a full electronic history of actual days on jobs will be retained. | Neil Hunter |
| 5 The Galileo time recording system should be used as part of the formal consideration of contingency levels in the operational plan in future periods. | ✱ | Contingency levels will continue to be estimated using recent history and will also reflect changes anticipated across the Council where accurate job identification and time estimation would be difficult, e.g. Childrens' Act. | Neil Hunter |

Appendix 2

IA Staffing Structure

