



COUNCIL OF EUROPE CONSEIL DE L'EUROPE

Local and Regional Democracy

Internal Audit at Local and Regional Level

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INTERNAL AUDITING IN REGIONS AND MUNICIPALITIES IN EUROPE

Introduction

In 1999 the Steering Committee on Local and Regional Democracy (CDLR) brought out a publication (volume No. 66 in the Local and Regional Authorities in Europe series) containing a report on supervision and auditing of local authorities' action and Recommendation No. R (98) 12 of the Committee of Ministers to member states, which had been issued subsequent to the report.

The main idea underlying the report and the recommendation is that supervision of local authorities' action must be kept in line with trends in local government, whose powers and autonomy are constantly growing in accordance with the principle that "public responsibilities shall generally be exercised, in preference, by those authorities which are closest to the citizen", established by the European Charter of Local Self-Government.

Strengthening internal control was one of the alternatives to administrative supervision suggested in the above-mentioned recommendation so as to afford continued guarantees, in this new context, of compliance with the principles of the rule of law and effective management of public assets in society's interests.

The advantages which local authorities derive from efficient internal control were also pointed out in the "Handbook of good practice - public ethics at local level" adopted by the Conference on Ethical Standards in the Public Sector held in Noordwijkerhout, the Netherlands, on 31 March and 1 April 2004.

The greater autonomy enjoyed by local and regional authorities and reductions in or elimination of a priori control, that is to say relaxation or eradication of supervision by a higher authority, indeed go hand in hand with an increase in the responsibilities of local government authorities and their senior executives from the political, financial, civil and criminal standpoints. This responsibility is all the greater in that those authorities' jurisdiction is becoming ever broader, with proportionate growth in their budgets.

It is accordingly in the interests of local and regional authorities and their managers to protect themselves, as far as possible, from the growing risks of all kinds to which they are exposed when managing their affairs and their budgets, and that is the very purpose of internal control. Internal control indeed corresponds to the organisational measures and procedures that an entity establishes to minimise its risks and to be able to achieve its objectives under optimum conditions.

However, introducing internal control arrangements is not enough. It is absolutely essential to review the internal control system on an ongoing basis so as to guarantee its effectiveness and make any necessary improvements to it. This task of verifying the quality and appropriateness of internal control is performed by the *internal audit function*. Its role is to validate internal controls on behalf of the local or regional authority's management.

It is on account of internal audit's essential contribution to the proper functioning of *internal control* that the CDLR considered it worth looking into the conditions under which local and regional authorities in Council of Europe member states have established an *internal audit function*, with a view to identifying any difficulties encountered and also any "good practices" and thereby proposing avenues for enhancing internal audit's effectiveness.

In order to prepare this report, the CDLR sent all member states two very comprehensive questionnaires, one concerned with internal auditing in regional authorities and the other with internal auditing in municipal authorities. The survey's objective was described as follows:

"The internal audit function can play a significant role in helping to ensure efficient, effective use of local authorities' resources and their allocation in line with the local population's needs and the programmes and policies approved by the municipal [or regional] authority. The purpose of this survey is to acquire knowledge of the Council of Europe member states' practices in the field of internal auditing and of the resources they earmark for that function. The replies will reveal where priorities lie - compliance audits or performance audits - in the different countries concerned. The surveys carried out so far have shown that there are significant differences between countries in both the role assigned to internal control and the organisation and conduct of operations.

With a view to identifying best practices, it is useful to know whether internal audit recommendations do in fact lead to an improvement in municipalities' [or regions'] risk control processes and in efficiency and effectiveness. Where there are obstacles to the implementation of auditors' professional recommendations, it is important that they should be identified."

Twenty-one countries responded in full or in part. Some states forwarded the questionnaires to a number of regions and municipalities, and produced a summary of the replies they received in return. The CDLR also received a number of completed questionnaires direct from regions or municipalities. In the majority of cases, the states concerned answered the questionnaire on the basis of their own, sometimes incomplete, knowledge of their local and regional authorities' practices. Overall, thirty-six questionnaires were returned to us, thirteen of which concerned regions and twenty municipalities. In addition, we received three responses not directly based on the questionnaire, which covered both categories of local government authority.

The following report does not confine itself simply to setting out the replies received, although it is based on the information contained in them. The importance attached to the various themes discussed in this report accordingly does not necessarily reflect the focus on them in the questionnaires.

I LEGISLATION GOVERNING INTERNAL AUDITING IN LOCAL GOVERNMENT AUTHORITIES

1.1 Countries without a national legal framework

Of the twenty-one states which answered the questionnaire only ten have legislation or national rules or guidelines requiring or recommending the introduction of internal auditing in regions and/or municipalities.

The states that lack national rules cited a very wide variety of reasons for this situation.

Sometimes no obligation is imposed on regional authorities because the country has a federal system of government, and the regions themselves are free to decide whether to require municipalities under their jurisdiction to establish an internal audit function.

Five countries consider that local government authorities do not need an internal audit function since the tasks normally incumbent on it are effectively performed by an external auditor, particularly as regards scrutiny and assessment of internal control. They describe their control system as "monistic".

These replies are more comprehensible if some background knowledge of the countries concerned is borne in mind. For instance, the Scandinavian countries have a very longstanding tradition of auditing in local government. These audits of the administration's action are qualified as external because they are the responsibility of council members, assisted by outside professional auditors. However, since those responsible for the audit function belong, in their capacity as elected representatives, to the authority being audited, and because they are also assisted by employees of that authority, they consider that their audits cover tasks which are elsewhere incumbent on the internal audit function.

The situation in Norway is nonetheless worthy of note, since, according to the reply received, the city of Oslo has set up its own internal audit department, which is occupied 80% with performance audits and only 20% with compliance audits. This decision by the country's largest municipal authority was probably influenced by the belief that Norway's traditional external audit system was not sufficient in order to undertake performance audits commensurate with the needs of a city authority managing a broad range of public services with a large staff and a considerable budget.

In Finland, the legislation requires that the executive boards of all municipalities organise the authority's internal supervision; the external auditors (appointed by the council) have to verify that this function is conducted properly. In addition, like in Norway, the largest municipalities have established voluntarily their own internal audit departments, which are attached to the executive boards. The internal auditors working in these departments are municipal civil servants. Based on their own work plans and assignments from the executive management, these departments conduct audits on both compliance with standards and performance.

In the case of other countries, such as Switzerland, which also deems that an internal audit function is pointless, on the ground that the external scrutiny exercised suffices to ensure the proper functioning of internal control, another, somewhat different, explanation can be offered. In Switzerland cantonal - and even municipal - authorities traditionally have financial control departments, which are attached to the authority concerned but enjoy considerable autonomy.

It is these internal control departments which are gradually assuming external auditor status. Nowadays, they are in actual fact frequently a halfway house between the internal and the external audit functions, and it is understandable that the need to duplicate the audit teams is not immediately obvious, at least for the smallest local government authorities, since it is the authority itself which covers the cost of the auditors, whatever their status. Here too, the control system can be described as "monistic".

1.2 Countries with a national legal framework

The Municipal Law in Finland provides explicitly that each municipality should establish an auditing committee whose task is “to assess whether the operational and financial targets set by the Council have been achieved”. This committee is deemed to be a part of internal audit although it reports to the council. This body has the right to request explanations from all executive bodies and municipal civil servants; the auditing committee does not take any assignments from the executive. In the Finnish system, the external chartered auditors, who are contracted by the council based on a tender, verify the finances and accounting.

Of the ten other countries which replied that they had national rules governing internal auditing in local government, six had adopted those rules in order to comply with the European Union's requirements when they were candidates for accession. That means that only four countries of the ten former EU fifteen who answered the questionnaire have "spontaneously" passed national legislation on internal auditing in local government.

It is nonetheless necessary to take account of the countries - including some which failed to answer the questionnaire - where, although local government authorities are not obliged to establish an internal audit function, they must comply with specific internal control procedures, which can be extremely strict.

That is the situation in France, where local government accountants (in the regions, départements and municipalities) are necessarily Ministry of Finance employees. They alone are authorised to handle local government funds (expenditure and income) and are required to perform various compliance controls, in particular before making any expenditure payments.

The controls include, for example, checking the availability of the necessary budget resources. This original internal control mechanism (a similar system also exists in Belgium) naturally covers only part of the tasks that may be assigned to an internal auditor; it has nothing in common with a performance audit, for instance. However, the emergence of a new approach to public-sector management, which in 2001 led France to adopt a far-reaching reform of the state budget, including its implementation and its supervision, is beginning to be felt also at the level of management and control of local government, and the legal definition of external control of local government authorities, as exercised by the regional audit offices (*Chambres Régionales des Comptes*), now refers to the concept of performance.

It is accordingly not inconceivable that the legislation governing the internal control of local government authorities will also be reformed in the near future, so as to bring it more into line with international standards, particularly those concerning internal audits, and thus allow more scope to address performance-related concerns in the light of the new responsibilities incumbent on local and regional authorities' managers.

It can be concluded from the above that, excluding the specific case of the current or former candidates for EU membership, and with the noteworthy exception of countries such as the United Kingdom, the Netherlands and Finland, the respondent states have in general so far not seen any need to require or encourage their local government authorities to establish an internal audit function. This situation could change if they were to consider that local government authorities too should be prompted to take tangible steps to follow new trends in managing public affairs, entailing a responsibility and performance based approach.

II PRACTICE, CODES AND PROCEDURES

2.1 Internal auditing practice

Where internal audits are provided for under national legislation, the respondents stated that this concerned all of the country's local government authorities, whether regions or municipalities. It is estimated in Slovenia that, although it is compulsory by law, internal audit in municipalities with less than 5,000 inhabitants is not performed as it should be.

Where internal auditing is not mandatory, that naturally does not prevent regions or municipalities from establishing an internal audit function. This applies, for instance, to Belgium, where two-thirds of regions have an internal audit department, and Portugal, where three municipalities out of every twenty are concerned. Such examples are, however, rare. Where reasons are given for not setting up an internal audit department, apart from the "monistic" approach to auditing already mentioned, cost is a major consideration.

In reply to the question whether "new trends in public-sector management, which favour delegation of responsibilities and focus more on performance than adherence to rules" had fostered growth in internal auditing, most countries responded in the affirmative. However, the comments accompanying the replies, and the scarcity of instances where internal audit functions have been established without any legal requirement to do so, show that new trends in public-sector management remain a still fairly abstract concern for many small local or regional authorities, and even for larger ones. The mandatory audit committees in Finland constitute a clear exception.

2.2 Codes and procedures

Where national rules exist, they usually lay down all of the internal audit function's characteristics and the procedures it is to perform and are binding on local government authorities of the country concerned (this is the case in Spain, Finland, the United Kingdom, the Netherlands, Hungary, Lithuania, Poland, Slovenia, the Slovak Republic and the Czech Republic).

In the United Kingdom the relevant practices are set out in the "Code of Practice for Internal Audit in Local Government", drawn up by the CIPFA (Chartered Institute of Public Finance and Accountancy), with which local authorities are required to comply under ministerial regulations (The Accounts and Audit Regulations 2003), themselves governed by the Local Government Act of 1972.

In Hungary internal auditing in local government is organised in accordance with the Act on Municipalities of 1990 and the Public Finance Act of 1992; the practical aspects are laid down in a government decree on Internal Auditing of Public Budgetary Organisations of 2003, which includes a manual containing examples of good practices in internal auditing. In the Netherlands all municipalities are required to have an internal audit function, but it is for them to determine how it is organised and the rules it follows, since central government confines itself to laying down general guidelines.

With or without national rules and regulations, an audit charter is usually drawn up and approved either by an Audit Committee or by the council (this applies, for instance, to the Brussels Capital region, the Flemish Region, the Swiss cantons and the Italian regions). The charter determines the status and role of the internal audit function within the local or regional authority concerned. The audit charter of a UK municipal authority is appended, as an example. The Finnish association of local authorities has also issued a model charter for municipal audit committees.

Reference to the standards of the Institute of Internal Auditors is not the general rule, and is even exceptional in municipalities' case. Although the replies to the questionnaires fail to indicate why no reference is made to these international standards, the likely explanation is that adopting such an approach makes more sense for large local government authorities able to set up an extensive internal audit department than it does for small municipal authorities whose internal audit function, if any, is limited to one or two members of staff. Moreover, a number of respondents pointed out that establishing an internal audit department is feasible only in large authorities. The question of adaptation of internal audit standards to the specific case of local government authorities might nonetheless be posed.

III STATUS OF THE INTERNAL AUDIT FUNCTION

3.1 The status of internal auditors in local government authorities

In the countries where internal auditing of local or regional authorities is separate from external auditing, the function is virtually always performed by a department of the municipal or regional authority. In the United Kingdom, where the choice is left to the authorities themselves, a private firm is used in some - exceptional - cases. The countries which replied that the internal audit function was entrusted to a private firm are primarily those with a "monistic" control system.

The replies concerning internal auditors' membership of an umbrella organisation are lacking in precision and must be interpreted with caution. Where such an organisation exists, it may be part of the national Institute of Internal Auditors (as is the case in Belgium, and to some extent the UK), that is to say an organisation not specific to the public sector, or it may be a general-purpose association specific to the public sector, bringing together auditors, accountants and financial managers employed in that sector (in the United Kingdom internal auditors may belong to the IIA and the CIPFA, mentioned above).

Of the replies received, only the Slovak Republic mentioned the existence of an association specifically bringing together the heads of internal audit of the country's municipalities. In other words, subject to confirmation and to more information on this point, it would seem that internal auditors in the public sector do not yet constitute a specific professional body.

This bears out the above conclusion that, as a specific activity, separate from external auditing and operational departments, internal auditing in the public sector is still in its infancy, which is also a further explanation for the lack of international standards specific to internal auditing in the public sector.

3.2 Recruitment, salary levels and qualifications

It follows from the above that, apart from under the "monistic" control systems, internal auditors are always recruited by the authority which employs them. The question then arises as to whether difficulties are encountered in recruiting suitable staff, in particular as a result of differences between public and private sector salary levels, and whether the overall staffing situation is considered adequate in the light of the tasks to be performed.

The replies regarding salaries are fragmentary and non-committal. The majority of respondents nonetheless consider that salary levels are sufficient, although some mentioned that public sector auditors are paid less (according to one reply 10 to 30% less) than those in the private sector. However, this does not engender recruitment problems.

Although staff's qualifications are considered largely sufficient, the same cannot be said of their numbers, which are deemed inadequate in a majority of countries. This is mainly attributable to budget shortages.

3.3 Training and quality assurance

- Training

It is naturally of prime importance that internal auditors in the public sector should, like all auditors, be fully qualified, since their role is to analyse public authorities' functioning so as to detect any risks or weaknesses and propose corrective action or improvements. It must also be pointed out that their competence is no longer confined to matters of compliance with accounting, budgetary or other regulations (including, for example, public procurement rules) but must extend to performance-related matters.

Nowadays, internal auditors within public authorities, in particular local and regional government, must be capable of analysing the procedures and processes underlying the supply of public services, in order to assess whether those services are rendered to their users' satisfaction (effectiveness) and also in an efficient, economic manner (cost-efficiency). That does not mean that a single individual - one and the same auditor - must alone master all the skills that an audit department is required to offer. It is true, however, that due to budgetary constraints the smallest public authorities are unable to recruit a number of internal auditors.

It is accordingly essential that internal auditors in small organisations should be properly trained, so as to be able to review by themselves not just issues of conformity, but also those linked to performance, at least as regards their most basic aspects.

The replies to the two questionnaires provide many examples of training schemes for auditors. Organising such training is a matter for each local government authority, with the assistance of specialist professional associations. The most striking difference that can be noted is that in some entities it is the auditors themselves who decide what training they will undergo, whereas in others there is a standard in-service training programme, which is compulsory for all auditors.

For instance, auditors employed by the Flemish Region in Belgium are required to devote 5% of their time to training, giving an average of ten days per year, and, at the same time, are required to keep abreast of developments in their own specialist sectors. In this area too, differences are linked to the size of the local government authority and of its internal audit department, which, according to the replies received, can range between one individual and some thirty people.

In general, it is of course preferable to have a systematic training programme compulsory for all auditors, regardless of the size of the department concerned and of whether this programme is devised by the local government authority itself or left to the professional associations to which the auditors may belong. National government authorities may also set up suitable training courses for public-sector auditors (as is the case in the Czech Republic, where courses are run under the aegis of the Ministry of Finance's Central Harmonisation Unit for Financial Control).

- **Quality assurance and external review**

In addition to training, **quality assurance** of internal audit services results from control procedures implemented within the departments themselves (in the Flemish Region and Poland) and/or periodic assessment by an external body. Some local authorities (in the United Kingdom) even go so far as to have their audit departments ISO accredited.

In general, any external review is performed by the external auditor (whether private or public), by a specialist public body (such as the CIPFA in the United Kingdom) or by a supervisory authority (Ministry of Finance). Certain review assignments can also be performed by a specially appointed international audit firm (in particular in the case of internal auditing of use made of financial assistance granted under the European Union's structural funds - example cited by the Czech Republic).

Only ten respondents stated that the work done by internal auditors of regions and/or municipalities was subject to periodic review. The questionnaires asked about the reasons for conducting such periodic reviews:

- to verify that professional standards are being observed
- to improve audit quality
- to assess the value of the auditors' input to the management of regional/municipal affairs
- to make the auditors accountable to the authorities and the population
- to motivate the auditors and allow the introduction of performance-based pay
- other reasons.

Only the first two objectives were systematically cited in the replies; occasional mention was made of the others. Only three of the six UK municipalities whose answers were forwarded to us include assessment of the value of auditors' input to management among review objectives. These responses, even if few in number, show that it is easier to assess the quality of the resources utilised than the results achieved through their use. In other words, the difficulties encountered by auditors in assessing the performance of the organisations they audit also arise in appraising their own performance.

The questionnaires also listed means of measuring auditors' performance and asked which were in use:

- Customer satisfaction: management
- Customer satisfaction: regional/municipal departments audited
- Compliance with professional standards
- Costs (per engagement, per day, etc.)
- Report quality
- Auditors' experience
- Coordination with external auditors

- Number of recommendations implemented
- Compliance with reporting deadlines
- Speed of response to management's requests

While reiterating that the responses were few in number, it can be concluded that the proposed means of measuring internal auditors' performance have been validated by the respondents and are to be recommended.

In conclusion, although quality assurance and external reviews are not undertaken in all the respondent states, or by all the authorities concerned, it must be said that they are essential to the effectiveness of internal audits (and indeed external audits).

3.4 Independence

All of the respondents consider that internal auditors' independence must be guaranteed. Finland, however, reminded that the internal auditors cannot be fully independent, because he/she is appointed by a body subordinate to the municipal authority to which he or she is attached and takes assignments from the executive; the auditing committee instead fulfils this requirement. Independence of the internal audit department and its' members individual independence are regarded as closely linked, and in most cases no distinction is drawn between the two.

Independence is usually guaranteed by law, although it may be for the local government authority itself to ensure it in practice. Apart from this legal protection, the respondents stated that internal auditors' independence was guaranteed by:

- the existence of an internal audit charter;
- the fact that the auditors are functionally answerable to an audit committee including independent experts or a committee of the elected council;
- the fact that the auditors are not involved in management (they have no operational responsibilities);
- the fact that the head internal auditor's salary is determined directly by the elected council;
- the senior position held by the head internal auditor within the organisation;

- the external auditor (one reply mentioned that there were plans to make dismissal of head internal auditors subject to the Auditor General's approval);
- low turnover among auditors.

This last point - auditors' stability - is confirmed by the replies received concerning the length of time for which they may serve the same municipality or region, which is rarely limited (only two cases were cited, one with a time-limit of six years, and the other twelve). Assuming it is a source of independence - although the opposite might be deemed to apply - this stability can doubtless also lead to the formation of routine habits and have a negative impact on performance. Where it exists, this stability results in an even keener need for ongoing initial and further training programmes, as mentioned in point 3.3 above.

Virtually all of the respondents said that special precautions were taken to avoid or settle any conflict of interest and to guarantee auditors' impartiality, by ensuring that they cannot audit operations for which they previously held responsibility.

Similarly, measures are normally, but not systematically, taken to ensure that internal auditors who are not local government employees cannot perform several different types of assignment entailing problems of incompatibility (in particular the provision of both assurance and consulting services) for the same authority. It would appear desirable to make internal auditors subject to the same rules of ethics on concurrent provision of audit and consulting services as apply to external auditors (particularly since the infamous Enron case).

IV ORGANISATION OF INTERNAL AUDITS

4.1 Definition of internal audit's role

According to the replies received, regional and municipal authorities mostly draw up their own internal audit charters, based as and when necessary on any national legislation in such matters. Sometimes internal audit's role is defined directly by law (this is notably the case in most of the new European Union member states). As a general rule, these internal audit charters, or the internal regulations substituted for them, set out internal audit's tasks and terms of reference.

4.2 Organisation of internal audit engagements

- Planning

With only a few exceptions, internal audits are performed annually according to an audit plan, which is also annual in nature. Some organisations also have interim plans. In some cases the annual plan is part of a longer-term audit strategy, spanning three to five years for example (in Belgium's Flemish Region).

Virtually all of the respondents stated that the plan was based on prior risk analysis, although some audits of fundamental areas were systematically included. Risk analysis is performed using a multi-criteria approach, and some fairly sophisticated systems (scoring systems, for instance) were cited. Here are two examples of replies from UK municipalities:

- *Some audits included in the audit plan are always included such as those for fundamental systems. Other audits are included in the audit plan on the basis of risk assessment. All potential audits are assessed according to 6 areas. These cover materiality, business risk, audit experience, other assurance statements, fraud and time since last audit. Each area is scored from 1 for low risk to 5 for high risk. Using the total score for each area the highest risk areas are then planned into the Annual Audit Plan from resources available.*

– *Our risk assessment process assesses 7 key areas:*

1. *monetary / financial value*
2. *volume of transactions*
3. *devolution & delegation*
4. *contracted out services, where appropriate*
5. *system factors (knowledge)*
6. *managerial and control environment*
7. *sensitivity – political/other*

- **Definition of individual audits**

In general, each individual audit will be covered by a document setting out the audit's objectives and scope, its duration, cost projections, proposed working methods, and so on. This document is useful for the internal audit department's own internal control purposes, but, according to some replies, it is also a means of providing the entity being audited with information on the conduct of the audit.

Some respondents stated that, despite prior definition of the audit at the planning stage, the auditors were nonetheless allowed some discretion to adjust the audit's objectives and scope to take account of specific situations encountered on the ground.

- **Methodology**

Audits are usually performed in accordance with a standard work programme and with specifications, which are also standard and are in principle drawn up by the head of internal audit, sometimes subject to an audit committee's approval. In some cases these performance standards have been certified ISO9000. Elsewhere, as in the Czech Republic, they have been laid down by central government authorities:

"Audits are carried out in compliance with standards. The head of the internal audit unit is obliged to ensure the compliance with standards at implementation of all audits. In the framework of its methodical and harmonisation activities, the Central Harmonisation Unit for the Financial Control of the Ministry of Finance of the Czech Republic makes reference to standards in manuals and handbooks, which are elaborated for internal auditors."

A degree of flexibility is nonetheless necessary since some audits are not suited to a standardised approach. This is reflected in the following reply received from a UK municipal authority:

"Standard audit programmes are used where the system and its control are known; otherwise, a programme is produced at the specific audit planning stage based on the key controls to be assessed."

The Flemish Region stated that only 60% of audits are performed according to a standard work programme. This reply is consistent with the same regional authority's answer to the part of the questionnaire concerned with audit objectives and scope:

"Depending on the type of audit, the objective and scope may be known and can already be communicated to the auditors at the planning stage. This applies, for instance, to internal organisation audits, reviews of strengths and weaknesses (performed on the basis of internal audit guidelines), ad hoc assignments and administrative review procedures."

"In other instances, the audited entity is known, but the objectives and scope (usually an area or a process of the entity concerned) are determined by the auditors themselves on the basis of their preparatory procedures. This approach facilitates responses to specific situations."

V EXAMPLES OF INTERNAL AUDIT ASSIGNMENTS

The fields that may be covered by internal audits are manifold. Formerly confined to reviewing management of the accounts, internal audits now concern all the areas and processes involved in the delivery of public services by a local government authority.

Furthermore, as we saw in the introduction, internal control - and hence also internal audit - is no longer solely aimed at ensuring the local government authority's compliance with the law, rules or contracts, but also at guaranteeing the attainment of high performance standards in the provision of services of all kinds (administrative, social, cultural, economic, etc.).

5.1 Review of internal organisation and the system of governance

In half of the countries which answered the questionnaires, the internal audit function systematically reviews internal organisation and the system of governance, sometimes annually, sometimes less often (every three years in Lithuania, for example). Here are the replies submitted by the sample of UK municipalities:

- *A number of governance audits are undertaken each year to identify potential weaknesses.*
- *Local Code of Governance developed – annual compliance audit against this code*
- *Yes, Governance is reviewed by internal audit as part of its work to review the Council's Statement of Internal Control. This area is also reviewed by the Council's external Auditors (Audit Commission).*
- *Part of Best Value review imposed by Government and also key elements of annual audit plan by law.*
- *An allocation of time is made for corporate governance jobs. These are performed throughout the year.*
- *An annual review of our Corporate Governance Arrangements is undertaken.*

Some countries which answered the question on review of internal organisation and the system of governance in the affirmative then used the text-box solely to comment on review of the internal control system. That raises the question whether internal control, as construed in those countries, does or does not include the audited entity's organisation and system of governance, and up to what level. Since discussion of definitions can sometimes prove sterile, this comment is made here merely to show that it is worth expressly raising the question of review of internal organisation and the system of governance and, if possible, obtaining specific answers.

At the same time, it should be noted that it is in the interests of organisations - local government authorities in the particular case under consideration here - that their internal audit departments' tasks should include a periodic - not necessarily annual - review of their entire internal organisation up to the highest level, including their system of governance. This is because general under-performance in a local government authority may sometimes be attributable not to a weakness in internal controls concerning routine procedures but to poor design of its managerial organisation and governance methods. Since the results of the internal audit are intended to help the authority concerned improve its management and deliver services with maximum effectiveness and cost-efficiency, it is in that authority's interests that the internal audit function should submit all relevant observations and possible recommendations to it.

5.2 Compliance audits

According to the replies received, this is still a significant area of internal audit departments' activities (in Hungary's municipalities it continues to account for 95% of the total workload). Compliance audits consist, inter alia, in verifying:

- procedures designed to guarantee that grants will be used in accordance with the defined objectives;
- the existence and observance of procedures designed to guarantee that public procurement contracts will be awarded in accordance with the principles of fair competition;
- accounting and financial management;
- budget implementation.

Some countries (Denmark, Hungary, Slovak Republic, Slovenia) replied that accounting audits represented 60 to 80% of the internal audit department's workload, which bears out the conclusion that internal auditing frequently continues to be not just compliance focused, but chiefly concerned with observance of accounting standards.

This finding shows that there is still a long way to go before the performance-linked new governance principles become widespread not only at central government level, but also in local and regional government. However, compliance audits no longer systematically take pride of place and may even be becoming of secondary importance, as can be seen from the above-mentioned example of the city of Oslo (where they account for just 20% of the department's activities) and the Finnish municipalities in general.

That naturally does not mean that compliance audits must be abandoned, in particular in the accounting sector, but simply, on one hand, that they are no longer enough and, on the other hand, that they must be adapted to the changing management environment. Tangible evidence of this lies in the current reforms of accounting standards themselves, not just in the private sector but also in the public sector.

5.3 Risk analysis

Risk analysis is a specific approach covering issues of both compliance and performance, since both failure to comply with laws, regulations and contracts and under-performance adversely affect the organisation's management.

Analysing internal procedures so as to detect any risks of failure to comply or under-performance in the local government authority's management is accordingly a preventive approach, which is one of the means whereby auditors can generate added value. The questionnaires included the following, incomplete, list of risks possibly addressed by internal auditors:

- Compliance with laws, regulations and contracts
- Budget implementation
- Keeping of accounting records
- Recovery of taxes and other revenue
- Reliability and soundness of financial information
- Sustainability of level of indebtedness
- Protection of assets

- Management of resources - human, financial and physical (wastage; under-performance; fraud and corruption)
- Unethical behaviour.

According to the replies received all internal audit departments appear to focus on these areas in their risk analysis either systematically or at least occasionally on the basis of their own risk assessment performed before the audit planning stage (see point 4.2 above).

5.4 Performance (or added value) audits

- Planning

We received few replies to the question how internal performance audits are organised, which would seem to bear out the fact that such audits are currently undertaken by only a minority of local government authorities. The responses themselves are more often than not imprecise. Some state that performance audits are included in the general audit plan, of which they are one focus, without giving further details.

However, in Belgium's Flemish Region performance audits are conducted concurrently with operational audits. "*Analysis of strengths and weaknesses focuses virtually exclusively on attainment of objectives*" and "*must show whether the organisation has the management and planning instruments necessary to support its efforts to attain its objectives.*" In Finland, the auditing committee focuses entirely on 'performance and targets', the internal audit departments give their attention to both compliance with standards and performance issues.

In the United Kingdom municipalities systematically undertake internal performance audits. The following is an example:

"The Council's Key Priorities and themes as given in the Council Plan are used as a focus for the aims of the Internal Audit Service Plan. In doing so it is the aim of Internal Audit to always consider issues of economic use of resources in any audit. Internal Audit's responsibilities for economy, efficiency and effective use of resources are discharged through a planned series of audits and reviews throughout the year. Internal Audit requires the authority to critically examine its approach to service delivery and in doing so demonstrate proper and best use of resources in any work it undertakes."

The few detailed replies received to this question accordingly confirm that the starting point for organisation of a performance audit must be consideration of the local government authority's objectives, followed by analysis of whether the procedures and processes necessary to their attainment have been established and, in the affirmative, whether they are the most effective and efficient.

- Review of procedures for setting priorities

In the section of the questionnaires concerned with performance audits we asked whether procedures for setting priorities regarding use of budgetary resources were subject to a specific review. Most of the respondents answered no; in some cases the central government agencies which dealt with the questionnaires specified that they had no information on this matter. The reply received from the Czech Republic offers a good illustration of the difficulties posed by this question:

"In the framework of division of management competencies, there is a procedure within the system of administration and management of a public administration authority, how to determine priorities for the financial management on the basis of the approved policies.

Within the legal framework in force (Act on Regions, Act on Municipalities), these specific controls are concurrently provided by the obligatorily established financial committees as the initiative bodies of the relevant municipal or regional councils.

At present, when the internal audit service is still under development, it cannot be responsibly stated, if the internal audit units of the Regional or possibly Municipal Offices somehow participate in this issue."

An explanation for these negative or very evasive replies can be suggested. Setting budget priorities and objectives is primarily a prerogative of elected councils, and it is then for the administrative arm to implement the budget and establish means of attaining the objectives.

It is accordingly quite logical, on first analysis, to consider that internal audits, specifically internal performance audits, must be confined to reviewing whether the administration has established the processes and procedures best suited to attainment of the elected council's objectives and implementation of the budget approved by the latter, without it being necessary to examine the conditions or procedures under which those objectives and the corresponding budget priorities were set.

This is an area on the borderline between performance auditing and review of expediency, and the issue is problematic in the case of both external and internal auditing. However, it must be pointed out that the question posed relates not to the choice of objectives and priorities, but to the *procedures* applied to determine them.

In some countries external auditors, particularly where they belong to public bodies such as an Auditor General's Department, already consider themselves entitled to issue observations on the procedures used for setting budget priorities. It is therefore not unreasonable to envisage that the internal audit function might also focus on this aspect of *internal control*, in so far as internal control encompasses all the processes and procedures which allow an organisation to function in accordance with its primary purpose.

In conclusion, without going so far as to *recommend* that the internal audit function review procedures for setting objectives, or even merely budget priorities, it is no doubt possible to point out that there is no reason why a local government authority should not include review of these procedures in its internal audit charter, where it deems appropriate.

- Determination of anticipated results

Since precise definition of the anticipated results of a programme or specific measure is necessary to allow assessment of whether those results have been achieved, we asked whether auditors generally concerned themselves with this matter.

A number of countries replied in the negative, but this does not necessarily mean that they disagree with the principle raised by this question. These negative replies were primarily received from countries with a very strong, longstanding tradition of accounting audits and (internal or external) compliance audits. They can accordingly be attributed to the fact that, since performance audits are not a customary practice in the countries concerned, the question of determination of the expected results of policies implemented by the authorities being audited does not arise there.

One thought-provoking point is that no positive reply to this question was received from the United Kingdom, where performance audits have been widespread for a number of years now. Since the replies to the questionnaire say nothing further, an attempt can be made to offer an explanation for this situation.

It must be said that, although precise determination of anticipated results is clearly necessary to allow assessment of their achievement, it nonetheless cannot be assumed that all public policies lend themselves to prior determination of quantified results or objectives.

A public authority can take a clear decision as to which specific policy it wishes to implement, in which field and for which target population group, and it can also determine in clear-cut terms which resources it intends to devote to that policy, but it is not necessarily able to say what *precise* results it anticipates. Is it pointless to pursue an urban crime reduction policy, requiring the investment of significant financial resources, if the exact outcome expected cannot be announced at the time of the policy's adoption, or is fighting crime not in itself a sufficiently valid general, unquantified objective?

This doubtless accounts for UK municipalities' tendency to base performance reviews solely on indicators, not necessarily linked to expected results. This approach focuses on costs and the standard of services delivered, particularly by using a benchmarking process to compare these from one municipality to another, rather than on local authorities' success in achieving the objectives they set themselves. At the same time, indicators may bring to light shortcomings in the objectives set, without it being necessary for the (internal or external) auditor to comment directly on them and hence run the risk of being rebuked for reviewing the expediency of policy decisions.

There is also another possible explanation why internal auditors are rarely responsible for verifying that precise performance objectives accompany local authorities' policy programmes and measures. Failure to achieve anticipated results may indeed have two different causes.

Firstly, there may have been weaknesses in the implementation of the programme or measure, and in that case the internal auditor has a justifiable, valuable role to play in shedding light on deficiencies in procedures or processes. Secondly, the elected council's expectations as regards the anticipated results may have been unrealistic, accounting for failure to achieve them. This second possibility brings us back to the above comments on review of priority-setting, with the risk that entails of encroaching upon the council's prerogatives.

One reply to the questionnaire (from Belgium's Flemish Region) nonetheless aptly sums up the advantages of reviewing precise determination of the anticipated results of a programme or a specific measure:

"It is important that objectives be defined and quantifiable, that the result to be attained or the expected improvement be expressed in terms of measurable outputs. Auditors often check that the objectives of a process or of the organisation are SMART [specific, measurable, achievable, realistic and timed]. This kind of review of objectives and the related indicators are an essential component of certain operational audits."

In conclusion, it is doubtless not possible to *recommend* that internal auditors systematically verify whether the programmes and measures decided by elected councils go hand in hand with precise performance objectives, but it is nonetheless desirable to *point out* that nothing prevents a local government authority from including such reviews in its internal audit charter, where it deems appropriate.

- Review of relevance of results assessment criteria

Most of the replies to the questionnaires state that it is for the internal auditor to verify the relevance of the results assessment criteria established by management. For clarity's sake, it should doubtless be pointed out that these are the criteria laid down by management for assessing the results of its own activities, even where those activities consist in implementing programmes and measures decided by the council.

This is an important question since, depending on the chosen criteria and how they are laid down, the presentation of the results of a given measure may be slanted in an entirely different way - positive or negative. This is one clear example which shows why internal auditors must enjoy genuine independence, including vis-à-vis the management of the organisation that employs them.

However, in such matters the professionalism of the auditor, whether internal or external, is critical to the success of the audit but does not suffice in itself, since, although they have their limits, indicators should be used to draw comparisons through a benchmarking process, as mentioned above. This requires that the indicators should, as far as possible, be common to the largest possible number of organisations active in the same field.

To cite a simple example, if the aim is to compare the costs incurred by a number of local government authorities for school buildings in the same category, a decision must be taken as to whether the cost will be assessed per square metre or per pupil, or both. In addition, for each indicator selected all the authorities concerned must apply exactly the same calculation method, even down to the smallest details.

Joint definition of management indicators in local government may be a task for either professional associations of managers and auditors, naturally including internal auditors, or for central or local public authorities, or an entity bringing all these parties together. The cardinal requirement is that the indicators should be common and recognised by all those likely to use them in any capacity.

- Recommendations subsequent to a performance audit

Many of the replies received from countries where internal performance audits are commonplace consider it self-evident that one outcome of such audits will be advice to management on improving processes, reducing service delivery costs and enhancing efficiency and effectiveness. The terseness of the following reply serves as an illustration of this:

Question: *"Do audit reports include recommendations on procedures to be implemented in order to promote a more expedient allocation of resources?"*

Reply: *"Depends on the audit".*

However, the above standpoint is not a matter of consensus and could possibly be perceived as a legacy of old attitudes to internal or external auditing, which tended to reduce the audit function's role to providing assurance of accounting records' compliance with the relevant standards and rules. In the case of reviews of performance, and in particular of the processes and procedures which enhance or undermine performance, the point of the exercise clearly lies in issuing recommendations or advice which will help management, at various levels, improve the effectiveness and efficiency of public services delivery. The introduction to the standards published by the Institute of Internal Auditors says exactly the same thing:

"Internal auditing helps an organization to accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes, in making propositions for reinforcing their effectiveness."

There would appear to be all the more need to underline the advantages of producing internal audit reports, including performance audit reports, which incorporate any advice and recommendations the auditors can draw from their work and from their professional skills, in that the reports in question are primarily addressed to the management of the organisation being audited and are not usually intended to be made public, save where exceptionally provided otherwise. It accordingly seems inappropriate for reports issued by internal auditors of regional or local authorities to be as concisely worded as those produced by external auditors reporting to a general meeting of shareholders of a private firm.

In all likelihood, where a performance audit is not undertaken or where such an audit fails to result in recommendations, the cause will lie in the fact that the auditors are not properly qualified for the job, since they have received only traditional training in the performance of accounting audits, as mentioned above. Developing the practice of performance audits entails a considerable effort to recruit suitably qualified staff and provide in-service training. This lends even greater weight to the above recommendations regarding the training of internal auditors. Introduction of performance audits also warrants that particular attention be paid to appraisal of the internal audit function itself, as already discussed earlier (section 3.3).

VI COMMUNICATION OF INTERNAL AUDIT RESULTS

6.1 To whom are internal audit reports addressed?

The respondents were unanimous that the audit report takes the form of a written document, although some of them refer to the new information and communication technologies and mention use of e-mails. Some point out that a written report does not preclude making oral comments, which of course stands to reason.

The reply to the above question is a key to understanding the status of the internal audit function within an organisation of any kind, but all the more so in a public authority which combines administrative and policy-making functions.

To a certain extent a reply was suggested in the questionnaires themselves, since the introduction ("Objective of this survey") stated: *"internal audit findings are intended for management or the municipal authority, unlike those of external audits, which are communicated to the legislative authority."*

Most of the replies in fact specify that the head of internal audit reports to the Chief Executive or the Head of Finance and Accounting. However, some replies mention the "executive" (the Netherlands and Finland) or an "audit committee" (the Flemish Region), which in turn reports to the council, i.e. the elected assembly. In Finland, the auditing committees like the external auditors report to the council.

In countries where no distinction is drawn between internal and external auditing, the end recipient of reports is naturally the elected council (this applies to Switzerland, Sweden and Denmark). Nonetheless, even in countries where internal auditing is clearly separate from external auditing, internal audit reports may be communicated to the council (the Slovak Republic said this was the case).

In view of the diversity of practices, it is difficult to issue standard recommendations in this area. The principle whereby the external auditor reports to the legislative body, whereas the internal auditor reports to the executive (management) has the merit of being clear and simple.

However, some respondents stated that the manner of communicating the information consists in having the internal audit department report to an ad hoc committee, including representatives not just of management but also of the elected council and/or independent experts. This approach offers the advantage of enhancing the internal auditors' independence.

The existence of an audit committee reduces the not always hypothetical risk that the internal audit function's recommendations aimed at increasing the reliability of procedures and enhancing the effectiveness and efficiency of service delivery will be disregarded by senior management. It also solves the issue whether, in the event of a serious problem, the internal auditors can make public the results of the audit, a question which most respondents, but not all, answered in the negative.

The solution of setting up an audit committee, including representatives of the elected council (the legislative authority), therefore has the merit of preserving the necessarily confidential nature of audit results, with it being up to the elected representatives on the committee to assess whether the seriousness of the findings or their implications necessitate that they should themselves report the situation to the elected council. The same responsibility may rest with independent experts if they alone sit on the internal audit committee alongside the senior executive.

6.2 Publicising the audit report

Regarding the possibility or requirement of making internal audit reports public the replies varied. This can mainly be attributed to the differences in internal auditors' status between countries. In those with a "monistic" tradition, where internal and external auditing are merged, the audit report becomes public as a result of its communication to the deliberative assembly, as is the rule with any external audit report.

In other countries where a clear distinction is drawn between internal and external auditing, internal audit reports are as a general rule not public. In cases where the report is communicated to the elected council, that body is under no obligation to publicise it. The actual conditions governing communication of the internal audit report to the council, where provided for, nonetheless remain to be ascertained, and it remains to be seen whether the very fact of its communication results in its becoming public.

However, internal audit reports may possibly be public in nature for other reasons. For instance, the Flemish Region in Belgium is covered by an Act of 1994, laying down the general principle of the public nature of government. According to the reply to the questionnaire, this principle also applies to internal audit reports, although it is specified that "*internal auditors do not issue any statements regarding audit reports.*" This doubtless must be understood to mean that a member of the public can have access to audit reports on request under the same conditions as apply to other government documents.

In conclusion, there does not appear to be any need to issue any further recommendation other than that ensuing from the previous section, viz. confidential communication of audit reports to management or an audit committee, responsible for deciding whether to inform the elected council of its contents, with it being left to the council to publicise the report if necessary, naturally subject to observance of existing legislation on publicising government documents.

VII IMPLEMENTATION OF RECOMMENDATIONS

7.1 Monitoring of follow-up action given to observations and recommendations

The answers to the question whether appropriate corrective measures are taken as a result of the internal auditors' findings of weaknesses show that the follow-up action varies considerably. Moreover, where the respondents answered yes, they failed to provide the details requested in the questionnaire. On the other hand, the two very similar questions concerning monitoring of implementation of recommendations met with fuller replies.

Most of the respondents concur that the head of internal audit is entitled, and possibly obliged, to verify that recommendations have been acted upon and to draw management's attention, via fresh observations, to any abnormal delay in implementation. In some cases monitoring of implementation of recommendations takes the form of a new audit engagement, known as a "follow-up" engagement, undertaken six or twelve months later.

One respondent even stated that, if failure to implement a recommendation was not immediately remedied by management on receipt of official notification from the head of internal audit, the problem was reported to the Auditor General's Department.

7.2 Information from the external auditors to the deliberative assembly

Further to the above comments, it can also be pointed out that the respondents all stated that the external auditors (Auditor General's Department, National Account Office – NAO –, etc.) took the internal auditors' observations into account and mentioned any shortcomings in management's implementation of internal audit recommendations in their own report to the elected council. In Finland, the Local Government Act requires external auditors to review implementation of internal audit recommendations.

VIII RELATIONS BETWEEN THE INTERNAL AND THE EXTERNAL AUDITORS

The following four questions were asked on this subject:

- Does coordination between the internal and the external audit functions exist?
- Do those in charge keep each other informed of their work programmes?
- Is there a formal exchange of information? If yes, which information (plans and programmes, audit reports)?
- Are their joint training schemes or exchanges of staff?

Apart from the last question, to which virtually all the replies were negative, respondents generally answered yes. The following are three examples:

- *The National Audit Office gets annual plans as well as annual performance report of IAUs and performs its audits in co-ordination with them. (Lithuania).*
- *External Audit need to be able to place reliance on the work of internal audit so Internal Audit provide external audit with a variety of information regarding the work they are doing and the principles/standards to which it is undertaken. These include: Annual Audit Plans, Service Plan, Performance Targets, Audit Reports and Audit Files. (reply received from a UK municipal authority)*
- *The Internal Audit Department and the Auditor General's Department consult each other on a regular basis. Special attention is paid to the audit methodology used, to planning and to audit objectives. The aim is to avoid duplication of efforts, to foster complementarity and to ensure that the load on the organisation being audited is not too heavy. No formal consultation process has yet been instituted with external audit firms specialising in public-sector audits. (Flemish Region)*

These replies show the benefits to be derived from consultation, and to some extent co-operation, between internal and external auditors, and indeed the need for such an approach.

To be more precise, it is for the internal audit department to co-operate with the external auditor, since the latter is the local or regional authority's "supreme auditor", whose work as the ultimate control body should be facilitated wherever possible. Indeed, in some respects the internal audit function amounts to a first level of control, with responsibility for ensuring, by applying appropriate methods (a sign of the internal auditors' professionalism), that the organisation's procedures and processes are valid.

In reviewing the quality of the internal auditors' work, the external auditor can more quickly form a sound opinion of the audited organisation's strengths and weaknesses. In any case, consultation with the internal audit function enables the external auditors to have a better idea of the areas on which their own procedures should focus and the nature and scope of the procedures to be performed in each area.

Co-operation between internal and external auditors is accordingly to be encouraged and recommended. However, this recommendation must come with a warning. Care must be taken to ensure that the exchange of information and the efforts to coordinate work programmes and audit engagements do not, in the end, result in subordination of one auditor to the other, or in a form of de facto supervision, even if exercised by the external auditor over the internal auditor.

Internal audit must cooperate fully with the external auditors, but must continue to focus primarily on serving the needs of its "customer/principal", i.e. the management of the authority to which it reports. The "customer" must remain free to determine which tasks it will entrust to its internal auditor, even though, as we have already seen, the latter must be fully independent in performing those tasks if internal audit results are to be of some value. According to the IIA standards, it is only with regard to assurance engagements that internal auditors themselves determine the nature and scope of the audits they perform.

At all events, external auditors always have sole say regarding the engagements they perform, and, although they may communicate the results to the "legislative authority", they must remain entirely independent of it, as required under the INTOSAI standards. It also goes without saying that they must also be completely free from any form of influence by the internal auditor.

CONCLUSIONS AND RECOMMENDATIONS

Conclusions

The replies to the questionnaire are incomplete, since some key countries such as Germany (with a federal structure of government) and France (with a unitary structure of government) failed to respond. Furthermore, some of the replies received from central government authorities enter into few details regarding local and regional authorities' practices in these matters.

Moreover, one basic structural difference between the Council of Europe member states sometimes weakens the comprehensibility of the questionnaires/replies: it is the extent to which the state authorities are involved in and directly conduct auditing of municipalities/regions and to what extent auditing is solely a local matter within the framework laid down in the legislation.

Nonetheless, a number of conclusions can quite clearly be drawn from the replies received, and it is possible to supplement those conclusions with our knowledge of the situation in countries that did not reply.

The first conclusion is that there is a very wide range of practices.

Firstly, there are the countries, like the United Kingdom, where local and regional authorities have both an external and an internal auditor. For instance, municipalities in England and Wales are audited externally by the Audit Commission and are required by law to make their own internal audit arrangements. In Finland, in turn, all civil servants or bodies active in auditing are municipal without any interference of state authorities.

We have also seen that the new EU member states have recently established internal audit functions, with the EU Commission's assistance, and at the same time are subject to external control by their Auditor General's Department or equivalent.

In other countries central government does not have a policy of encouraging the establishment of internal audit functions, but, in Belgium for example, that has not prevented two regions (Flanders and Brussels Capital) from setting up their own departments, while continuing to be audited externally by the national Auditor General's Department.

Then there are the countries, strongly represented among the respondents to the questionnaire, where the traditional "monistic" control system blurs the theoretical differences between internal and external auditing, since, as in Switzerland's case, the auditors are frequently municipal or cantonal employees but the head auditor is appointed by the council (the legislative authority) itself and reports to it directly.

As a result, Switzerland's local and regional authorities are split, more or less fifty-fifty, between those which consider that they have an internal audit department (in which case they regard themselves as having no external auditor) and those who think they are in the opposite position, although they all have roughly identical audit systems.

Nonetheless, in Switzerland the tendency is for internal audit departments to become increasingly independent and to go over to external auditor status, which is all the easier for them in that they have long been reporting to the legislative branch. This tendency does not, however, undermine the monistic nature of the audit system.

There are also some countries (or some regions, where municipalities are attached to the regions) which consider that local government authorities have insufficient resources to establish an internal audit function and bear the related costs.

Lastly, there are countries, like France, where this matter is left to local government authorities' discretion, since central government relies on other means, in particular external control¹ arrangements, to verify due compliance with compulsory budgeting and accounting procedures.

We consider that the above should lead to the following conclusion.

¹ In the Anglo-saxon sense of *control*, rather than that of auditing.

With regard to the fundamental procedures for approving and implementing budgets and keeping accounting records, on one hand, and presenting budgetary and accounting information, on the other hand, the key concern is that effective arrangements should be made to ensure on an ongoing basis, at least annually, that the standards and rules in force are being complied with. The name given to the system is not important, provided that it exists and affords councils and the relevant higher authorities sufficient assurance regarding compliance.

It is nonetheless true, at least in the case of the largest local government authorities - principally regions and major cities, that this basic service is far from satisfying current public-sector management needs.

This is firstly because, due to the impact of decentralisation and economic and social development, local government is managing a constantly growing number of key public services, ranging from drinking water distribution, road maintenance, street-lighting and public transport systems to culture, education, health, etc. It employs hundreds, or indeed thousands, of people and deals with huge budgets.

The authorities concerned have need of a sophisticated internal control system, comprising clearly defined, validated procedures and processes, covering not just their budgets and accounts but all their activities. It is accordingly the entire internal control machinery, and not merely controls relating to accounts, which must be regularly audited, naturally in the authority's own interests but, above all, in the interests of the public, who rely on the services delivered and fund them with their taxes or by paying service charges.

The second reason, also linked to the ongoing decentralisation process, is that local and regional authorities are increasingly free from central government supervision and a priori control has been eliminated or reduced. Those in charge at the local and regional levels are accordingly now increasingly liable for their decisions. They have to take full responsibility for those decisions and answer for them to users, the electorate and even the courts, whether administrative, civil or criminal.

The third reason why the minimum guarantee of budgetary and accounting operations' compliance no longer suffices follows from the above. As a result of the importance of the services delivered by local government authorities and the size of the corresponding budgets it is no longer possible to manage those services solely from the standpoint of compliance with the relevant rules. The extent of the needs to be met and the scarcity of resources make effective and (cost-)efficient service-management a must. Compliance procedures must accordingly go hand in hand with service delivery processes designed to be as effective and economic as possible.

It is these three reasons which underlie the principles referred to as "new public-sector management". This approach is based on answerability of public-sector managers for achieving the objectives and policy results decided upon by elected councils, and for doing so with maximum cost-efficiency.

Today's public-sector managers, particularly in the largest local government authorities, cannot assume responsibility for attaining objectives and results if they do not endow themselves with permanent means of validating the procedures and processes allowing the achievement of objectives and of the results by which they will be judged.

External scrutiny is essential to provide elected councils with information on the manner in which the executive and local government officials establish the means of achieving the objectives and results they have set and to help them assess whether this action is a success or a failure.

However, managers, the executive and local government officials themselves need, as part of their governance process, to have the procedures and processes they adopt assessed and validated on a real-time basis. It is therefore for them to set up an internal audit function to serve their need for information as to the quality of their own management approach, in view of the objectives and results to be attained, and to afford them advice, consisting of analyses and recommendations produced with both professionalism and independence, the two cardinal rules to be met by auditors in their work.

The recommendations that could possibly be issued to Council of Europe member states are based on this analysis of the situation in the member states' local and regional authorities and of their needs, as they transpire from the replies to the questionnaire. The main recommendations proposed, which are set out in detail in the body of the report, are summarised below.

PROPOSED RECOMMENDATIONS

Financial supervision and supervision of management exercised at central government level

- **Remind** states of the provisions of Recommendation No. R (98) 12, adopted by the Committee of Ministers on 18 September 1998, calling on member states to:
 - *minimise the effects of financial supervision and supervision of management in so far as these can bring into question the expediency of choices made by local elected representatives*
 - *organise these two kinds of supervision in order to foster good accounting practices and the effectiveness of management, prevent financial imbalances, monitor financial rehabilitation of local authorities which encounter financial difficulties and enlighten citizens with complete and objective information.*

Internal control

- **Remind** states of the provisions of Recommendation No. R (98) 12, adopted by the Committee of Ministers on 18 September 1998, calling on member states to *strengthen internal mechanisms of supervision, in particular in the financial and management fields* as alternatives to administrative supervision.
- **Invite** member states to foster the development of internal control in local government regarding not only management methods' compliance with legal, regulatory and contractual obligations, but also the effectiveness and efficiency of delivery of public services and economic use of public funds under a performance oriented approach.

Internal auditing

Whereas, to be effective, internal control, above all where it encompasses procedures and processes aimed at guaranteeing the efficiency and effectiveness of management and of use of resources, must be audited on an ongoing basis for the benefit of the management of the local government authority concerned;

Whereas, although these audit activities may come within the external auditor's remit, external auditors do not perform their engagements for the benefit of local government authorities' managers;

- **Recommend** to member states to promote, through the channels most appropriate to each national and local context, the establishment of internal audit functions in local government authorities, regard being had to the budgetary and human resources available;
- **Recommend** that internal auditors:
 - perform their tasks not only in the field of compliance with budgetary and accounting standards and rules, but also in other fields of local and regional administration,
 - be assigned the task of reviewing the internal organisation of the authority concerned and its system of governance,
 - be assigned the task of reviewing procedures and processes relating to management's performance in the light of the objectives set and the results expected by the authority's deliberative assembly or council.
- **Recommend** that the internal audit function be established pursuant to generally accepted international standards, such as those of the Institute of Internal Auditors (IIA), notably as regards:
 - the adoption of an audit charter, defining the internal audit function's role, powers and responsibilities;
 - the conditions of independence of the internal audit function;
 - internal auditors' qualifications and training;
 - periodic appraisal of the internal audit function by a qualified outside body;
 - the planning, objectives, scope, resources and work programme of audit engagements;
 - communication and distribution of audit results;
 - monitoring of follow-up action given to audit results.
- **Recommend** to member states that they promote the introduction of internal auditing by establishing or fostering the creation of specialist professional bodies to provide local government authorities, particularly the smallest, with assistance and support in:

- drawing up their audit charters,
 - devising the necessary codes and procedures,
 - dispensing initial and in-service training to internal auditors,
 - appraising their audit departments.
- **Recommend** that internal and external auditors closely co-operate with due regard for one another's prerogatives and fields of competence.

Appendix
Audit Charter of the city of Sunderland in the United Kingdom

INTERNAL AUDIT SERVICES – AUDIT CHARTER

Statutory Role / Objectives and Responsibilities

Internal Audit Services (IAS) is an independent appraisal function established by the Council under the requirements of the Accounts & Audit Regulations 2003. The prime objective of Internal Audit Services is to assist management in delivering the objectives of the Council and its associated bodies through assessing exposure to risk and recommending, where appropriate, practical improvements to the control environment. To this end it is the responsibility of IAS to review, appraise and report to management upon:

- whether operations are being carried out as planned and objectives and goals are being met;
- the adequacy of systems established to ensure compliance with policies, plans, procedures, laws and regulations, i.e. rules established by the management of the organisation, or externally;
- the completeness, reliability and integrity of information, both financial and operational;
- the extent to which the Council’s assets, data and interests are properly accounted for and safeguarded from losses of all kinds, including fraud, corruption, waste, extravagance, abuse, ineffective management and poor value for money; and
- the economy, efficiency and effectiveness with which resources are employed.

Other Responsibilities

Internal Audit Services will produce a Strategic Internal Audit Plan, agreed by the Chief Finance Officer. In producing the strategic plan the Assistant Corporate Head of Finance (Audit) will have the freedom to determine the priorities for Internal Audit in consultation with the Chief Finance Officer and departmental heads, and will have an unrestricted range of coverage of the Council's operations. In general, but not exclusively, the priorities for Internal Audit will be determined by a process of risk assessment.

Each year an annual Operational Plan will be drawn up based upon the Strategic Plan and IAS will perform the audit work to the professional standards set out in its 'Quality System'. In addition IAS will seek to respond to requests for investigation into matters of fraud, probity and compliance that are client's responsibility. Furthermore, IAS shall have no responsibilities over the operations that it audits beyond the furnishing of recommendations and advice to management on risks and controls.

Reports

All material findings will be communicated to the relevant departmental management and once agreed a final report will be sent to the Chief Officer and, where appropriate, the Chief Finance Officer. Management is expected to implement all agreed audit recommendations within a reasonable timeframe and each audit will be followed up to assess the extent to which this has happened. In addition, the overall results of audit work will be reported quarterly to the Chief Finance Officer and annually to Cabinet or other appropriate body. The annual report will contain a view on the soundness of the Council's system of internal controls based on the work carried out by Internal Audit Services during the year.

Access

IAS shall have access to all officers, buildings, information, explanations and documentation required to discharge the audit role.

This includes not only the City Council, but also:

- organisations to whom the Council has given grants;
- organisations with whom the Council contracts; and

- partner organisations in any schemes for which the Council has responsibility as lead body.

Such rights of access shall be written into the appropriate agreements with these organisations.

Independence

Internal audit is required to provide an objective audit service in line with professional auditing standards. To this end IAS will have no executive responsibilities and the Assistant Corporate Head of Finance (Audit) will report directly to the Chief Finance Officer and have direct access to, and freedom to report to, all senior management including the Chief Executive and Members.