ANNEX 1

Auditing in an Economic Downturn

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This section evaluates the impact of the financial and economic crisis on public bodies and internal audit, and suggests ways of adapting to the new working environment.

Introduction

The current financial and economic crisis has impacted on many organisations and public sector bodies around the world. Consequently, it has had a major impact on the internal audit function within those public bodies as well. Many internal auditors will not have experienced an economic downturn and will need to adapt to a new way of working.

The public sector has had a reduced settlement from central government, a reduced (or no) pay settlement, and many ringfenced grants (except for education and public health) have been ended. The public sector has to reduce costs, either by efficiency savings, service redesign or direct staffing reductions, in order to balance its budget. There is continued pressure on managers and those charged with governance to deliver services that represent value for money.

The profile of internal audit has increased and internal auditors are increasingly being expected to think beyond financial controls and compliance with them, in order to be seen as adding value to management by providing independent assurance over the whole control environment (and therefore, worth maintaining). Internal Audit is expected to demonstrate value beyond financial controls.

Management, elected members and audit committees (or panels) expect internal auditors to be significant contributors in addressing the present challenges and to provide assurance on how well risks are being managed within their service areas. In order to achieve this, many internal audit sections will need to review their own processes and change the way in which they work. It is also important that internal audit sections participate in and promote best practice with respect to the audits they undertake.

Changes within Internal Audit

Impact of budget cuts

It will often be the case that internal audit sections are subject to the same budget cuts and spending restrictions that are imposed upon public sector bodies as a whole.

However, as staffing costs will invariably make up the majority of the cost of running the section, the result of the budget cuts will generally mean a reduction in the number of audit staff in the section. This has a consequential impact on the number of audits that can be undertaken during the year. Many organisations have imposed freezes on hiring new staff, so that if employees leave for other reasons they cannot be replaced, and there is an impact on staff morale as progression opportunities are limited.

Some internal audit services are partially or fully outsourced to private firms, and budget cuts may mean that fewer audit days can be purchased, which has a consequential reduction in audit coverage and assurance provided.

Although reductions in budgets will impact upon the audit team, internal auditors need to be mindful of the morale of the officers they are auditing, and the availability or co-operation of staff within the service areas. As within internal audit, staff reductions and freezes impact on staff morale as progression opportunities are limited and management need to be aware that low morale may lead to an increase in sick leave.

As well as reducing numbers as a result of budget cuts, audit sections may find their budgets reduced in other areas, including travelling and training. Training is essential to ensure that the staff that are retained have the right skills mix. Training and development budgets are often centrally held and it is therefore not within the direct control of the audit manager to ensure that his staff receive training as a priority over others.

In order to assess the effectiveness of controls, auditors will normally use a variety of auditing tools (such as computer assisted audit techniques (CAATs)) to enhance the depth of audit analysis and improve the efficiency of the overall audit process.

Auditors will need to increase the use of tools such as CAATs which allow analysis of large amounts of data to help identify anomalies such as high levels of overtime. These will help internal auditors to provide evidence which is empirically based, rather than just a broad understanding of the process. Although training budgets may be reduced, it is important that auditors remain up-to-date with the tools and skills necessary to do audits to a high standard.

Improving audit reporting

Improved audit reporting is also important, as is good communication between the audit team and the clients being audited. One way in which internal auditors can add value for managers and the audit committee is to provide assurance on the adequacy of financial and operational controls that are important to them and present findings in a manner that is easy to understand. Auditors can provide independent and objective feedback on areas of interest, as well as identifying potential risks and performance enhancing opportunities.

Partnership working

There is more pressure on audit teams to work in partnership with other public bodies and the private sector. Shared services with other bodies can occur for all audit services or specific ones such as education. The increased commissioning of services, which will be provided by various third parties (including companies, individuals, voluntary groups, big society volunteers etc), will mean a change in the type of audit work that will be undertaken. For example, there will be more procurement and contract audit work, for which auditors will need relevant skills.

Internal auditors also need to understand the relationships between all parties and ensure they are up-to-date with new service delivery arrangements to ensure that contracts/legal agreements provide the right of access by internal audit to third party records where required. Auditors may need to consider new ways of providing the necessary assurance that the service is being delivered well.

Treasury management

The impact of global financial and banking issues means that there is a need for internal audit to be alert to the impact on treasury management. Many councils have had to train audit committee members in this so they can fulfil their role regarding the management of key financial risks, and now report regularly on treasury management issues to audit committee meetings.

Changing the Audit Approach

Risk management

The economic downturn has had a major impact upon the way in which organisations in the public sector work, and it has caused many to reassess their ability to manage risk. As economic conditions change, the organisation’s risk culture and appetite may itself change.

In this new environment, there should be strong risk management and governance processes in place. Although internal audit is not responsible (or accountable) for risk management, it can provide assurance to the audit committee regarding the adequacy of risk management processes.

Realigning and revising audit plans

Internal auditors should ensure that their audits remain aligned to the needs of management at all levels, which may mean that some traditional topics (eg auditing financial systems every year) should drop out of the plan. Without this alignment, internal auditors may not add value to the needs of the organisation they work for. It is also important that audit committees are aware of the work that internal auditors undertake for the organisation and the implications of reducing or changing the focus of this work.

Once the audit plan has been agreed by the audit committee or panel, consideration needs to be given to whether the scope of the individual audits remains relevant. For example, specific operational risks may need to be reviewed. When scoping an audit, it is important to identify the level of assurance that would be required and to tailor testing to this. This is an area where the use of CAATs will be of benefit as it provides evidence which is empirically based.

The role of the audit committee itself will change. As well as receiving reports on audits undertaken and issues identified, the committee may perform a scrutiny function on service reorganisation and redesign. As costs and workforce are reduced, control becomes more important and members of the committee may request officers to attend meetings to provide updates and assurance that controls and risks are being monitored.

Many internal audit sections have increased their work on risk management, particularly in relation to change management. Internal auditors can promote and maintain the common definition of risk management that is used within their organisation for aspects of control such as budget setting to help the organisation achieve its strategic objectives.

Internal audit sections have changed the focus of their work by moving away from the more traditional audit areas (such as regularity audits) and concentrating on the risks that have emerged from the changing economic environment. A risk based approach should still form the basis of the work of an internal audit section; the audit plan should focus more on the risks that are critical to the business, rather than simply financial or compliance risks.

Since the economic downturn, audit sections have revised their audit plans with increased emphasis on areas such as:

- operational risks
- effectiveness of risk management
- proactive anti-fraud work
- cost reductions

- reputational risks.

The risk based annual audit plan remains, for many public sector bodies, a key element in planning their audit work, although it is recognised that many internal audit sections are moving away from an annual plan and have a more flexible approach to planning as priorities change during the year.

Identifying cost savings

Management may also expect internal auditors to identify and consider areas where cost savings are available. Budgets are such that it is important to secure savings in order to maintain frontline services to the public. However, the quick sale of assets or reducing repairs and maintenance in one service area may have the short-term aim of saving money, but could cause higher costs to be incurred by the organisation in the longer-term. For internal audit, it may mean undertaking fewer but more in-depth cross-cutting audits in order to identify savings are robust and can be applied across the public body.

Impact of change processes

The economic downturn and resultant budget restrictions has seen many public sector bodies reorganise the services that they provide. This, in addition to reductions in staff, could mean less scope for internal checks or segregation of duties within the service areas which increases the risk of fraud and error.

Changing processes and structures also means that long established reliable systems may need to be revisited in order to provide assurance that controls are still in operation. Even though there may not be any compulsory redundancies, staff may be redeployed to areas with which they are unfamiliar and there is a possibility that controls will not operate effectively for a short period.

Dealing with service redesign or reorganisation

Part of service redesign may be to use “lean systems” techniques, which can be seen as stripping back a process to its bare bones. Many organisations are using this as a basis for the changes that they are making in service delivery. Major transformation projects will include risk registers and logs and will capture risks to the control environment throughout the course of the review in order to ensure that the mitigation of these risks can be fully considered and dealt with. Internal audit is concerned about the risk to the control environment and making sure that streamlining processes or redesigning systems do not affect robustness and accountability.

Internal audit may be required to assess the plans for service reorganisation and redesign. In particular, it may have to test the assumptions made regarding savings to be made and the accuracy of the accounting procedures used to ensure that the proposals are robust and viable and contain sufficient "scenario planning".

Although many organisations employ project managers to ensure the successful implementation of plans and projects, internal auditors are often called on to assess the plans and act as a "critical friend" during the process, although care should be taken to ensure that auditors do not lose their independence and become part of the service redesign process. Increasingly, internal auditors are asked to be part of the development of new systems and processes, so have to split "advice and consultation" from independent assurance.

Fraud

One area which public sector bodies may see an increase in is fraud. This might either be within the organisation itself, or by members of the public or suppliers against the organisation (which are often reported by members of the public), as the economic situation will affect the financial circumstances of both individuals and suppliers. Members of the public may also be more inclined to report officers who they suspect of fraud or corruption.

Management may increasingly depend upon internal audit to monitor and investigate incidences of fraud as and when they arise, but this will have a consequential impact on the other work of the section. Each report needs to be investigated thoroughly, which reduces the amount of time that can be spent auditing, particularly if it results in disciplinary action against staff or police action.

Within the organisation, officers may take advantage of lax internal controls to perpetrate fraud and it is important that the boundaries set within financial and contract procedure rules and delegated powers are monitored and adhered to. It is clear that the failure to adhere to these governance arrangements and regulatory requirements could lead to a lack of value for money. Internal audit also needs to be aware that employees (and members) may seek to abuse their position for personal gain.

Another area of fraud that the public sector may be subject to is organised attacks, which often rely upon poor or lax application of internal controls. Examples of such attacks include:

a. alteration of cheque payees, which may only be identified when the correct payee contacts the organisation to query non-payment

b. contact from companies for payment of an invoice relating to goods not received or ordered/unsolicited invoices
c. letters submitted to creditors sections to inform them of changes to bank details which prove to be fraudulent
d. cheque “cloning”.

Sources of Further Information

- *A New Strategic Position: Redefining Internal Audit in an Economic Downturn* (PWC, 2009)
- Audit and recession (CIPFA Audit Viewpoint, October 2010)
- *The Financial Crisis and its Impact on the Internal Audit Profession* (The Insitute of Internal Auditors, 2009)