

The Code of Practice for Internal Audit of Category 2 Authorities (England)

1. Introduction

Category 2 authorities are required through legislation to “undertake an effective internal audit to evaluate the effectiveness of its risk management, control and governance processes, taking into account public sector internal auditing standards or guidance”.

As Category 2 authorities are not within the scope of the Global Internal Audit Standards for the UK Public Sector, the Smaller Authorities Proper Practices Panel (SAPPP), acting in its role as the recognised standard setter for Category 2 authorities in England, has developed the Code of Practice for Internal Audit of Category 2 Authorities (England), referred to as the Code of Practice. The Code of Practice provides a framework to assist authorities in establishing proportionate and effective internal audit arrangements, while supporting appropriate governance, oversight and assurance of the internal audit function.

Therefore, all authorities, other than those with no financial transactions, must undertake an annual internal audit of their accounting records and system of internal control.

2. Appointing an internal auditor

All internal auditor appointments must be approved by the authority.

The level of internal audit resource required will vary according to the scale, complexity and risk profile of the authority's activities and therefore needs to be proportionate. While the core areas subject to audit are broadly consistent across town and parish councils and other Category 2 authorities, the extent of testing required will differ depending on transaction volumes, the value and distribution of expenditure and income, the number of control processes in operation and the arrangements in place for financial monitoring and governance.

The time required to complete an internal audit should therefore be determined on a risk-based basis, taking account of the size and complexity of the authority, the scope of audit work required and the sample sizes necessary to provide adequate assurance. While smaller Category 2 authorities may require less audit time than larger and more complex councils or relevant authorities, it is unlikely that an effective internal audit in non-exempt authorities could be completed in less than five hours, with more complex authorities requiring proportionately greater audit resource.

Work carried out by the internal auditor is a paid professional service. In line with proper financial management, the authority must remunerate the internal auditor in accordance with the agreed letter of engagement and approved financial regulations, and every payment must be properly authorised, recorded and accounted for. Payments in kind, including gifts, hospitality or other non-monetary benefits, are not acceptable and must not be offered or accepted.

For the smallest Category 2 authorities, where the internal auditor does not require payment for undertaking the audit, as a contract will not be required, the terms of this arrangement should be formally recorded in writing. This helps ensure transparency and safeguards both the

authority and the auditor against any future disagreement regarding the nature or extent of the services provided.

2.1 Independence of internal audit

The authority is responsible for appointing an internal auditor who is demonstrably independent of the authority's financial administration, management and decision-making arrangements.

Individuals who participate in, influence or oversee the authority's financial affairs cannot be regarded as independent for the purposes of internal audit. Accordingly, the Clerk, responsible financial officer (RFO), members of the authority and their close associates, including family members, must not be appointed to undertake the internal audit function.

All appointed internal auditors must be able to annually demonstrate and evidence their independence for the complete financial year through a declaration of independence, either within a letter of engagement or other relevant declaration. Any relevant changes in circumstances that are known must be documented and provided to the authority before the appointment.

To safeguard independence, the internal auditor must not undertake any work that they will subsequently be reviewing as part of their internal audit fieldwork. Where a firm provides both internal audit and other non-audit services to the same authority, the firm must be able to demonstrate that effective safeguards are in place, such as separation of personnel, reporting lines and review arrangements. The authority must satisfy itself that those safeguards are sufficient before appointment and annually thereafter. Prohibited work includes:

- completing any part of the annual governance statement and Statement of Accounts, except for the annual internal audit report
- providing bookkeeping, payroll or accounting services to the authority
- preparing the authority's accounts or financial statements
- preparing or performing bank reconciliations on behalf of the authority
- acting as, or deputising for, the responsible financial officer
- making management decisions on behalf of the authority.

2.2 Competence of the internal auditor

The authority must appoint a competent person to carry out an effective internal audit. A competent person has the knowledge, skills, experience and professional judgement needed to carry out the work effectively.

All authorities should appoint an internal auditor who has relevant knowledge and understanding of local government financial management, legal frameworks and proper practices, and who demonstrates competence through either a relevant professional qualification, relevant experience or evidence of appropriate training.

Appropriate qualifications, training or experience should include coverage of:

- governance, risk management and internal control of a Category 2 authority
- basic bookkeeping and accounting processes in line with the Proper Practices Code for Category 2 Authorities (England)
- relevant legislation that applies to Category 2 authorities

- the Annual Governance and Accountability Return
- professional ethics.

Other relevant competencies include the ability to challenge evidence, identify inconsistencies and write an accurate audit report.

Evidence of relevant experience, training and qualifications must be requested at appointment. This may be included in the letter of engagement or other relevant documentation.

If the internal auditor does not demonstrate the required competencies, this must be reported to members at the earliest opportunity. Alternatively, the internal auditor must disclose this to members themselves. The authority should then ensure that the auditor receives appropriate training, support or independent oversight, or is replaced where necessary to protect the quality and integrity of the audit.

2.3 Professional ethics and conduct

Any internal auditor carrying out work within a council or relevant authority must understand the importance of ethics, in particular:

- **independence/objectivity** – internal auditors must not allow bias, conflicts of interest or undue influence to affect their judgement
- **integrity** – internal auditors must be honest and straightforward in all work carried out and must not allow others to influence their work
- **due professional care** – internal auditors are responsible for carrying out their work with appropriate skill, diligence and judgement, applying a level of scrutiny that is proportionate to the authority's size, risks and complexity
- **confidentiality** – it is the internal auditor's duty to protect information obtained during their work, ensuring it is not disclosed or used for any purpose other than the audit without proper authority.

If the internal auditor does not demonstrate behaviours in line with these professional ethics and conduct considerations, this must be reported to the members at the earliest opportunity.

Alternatively, the internal auditor must disclose this themselves to members to ensure that they receive appropriate training, support or independent oversight to undertake the work effectively, or are replaced where this is necessary to safeguard the quality and integrity of the audit.

3. Risk-based audit

All internal audit work must be planned, scoped and carried out using a risk-based approach. The nature, extent, sample sizes and coverage of audit testing should be based on risk, not simply on completion of a prescribed checklist.

Internal audit work should be carried out throughout the year and not just at year-end.

It is not the role of the internal auditor to check the figures in the AGAR before it is presented to external audit for the limited assurance review.

When deciding the audit approach, the internal auditor should consider the authority's size, complexity, governance arrangements and risk profile. Factors that may affect the scope of work, sample sizes and testing coverage include:

1. the volume and value of financial transactions processed by the authority
2. the complexity of the authority's financial arrangements, including the use of earmarked reserves, borrowing, loans, investments or significant grant funding
3. the extent of staff delegation and segregation of duties, particularly where limited staffing resources may increase control risks
4. the effectiveness of key financial controls, including bank reconciliations, payment authorisation, budget monitoring and financial reporting
5. the authority's governance arrangements, including compliance with statutory requirements, standing orders, financial regulations and decision-making processes
6. the scale and complexity of contracts, procurement activity and any capital projects being undertaken
7. changes in personnel, systems, processes or governance arrangements since the previous audit
8. previously reported audit findings, unresolved recommendations or identified instances of non-compliance
9. the authority's arrangements for managing information, data protection, cybersecurity and use of IT
10. any actual or potential legal, regulatory, financial or reputational risks facing the authority.

The annual internal audit report within the AGAR is intentionally high-level. Its control objectives provide assurance over key statutory and financial governance requirements.

However, a risk-based internal audit should also consider whether there are additional areas of risk that are not covered by the AGAR control objectives. This is where the competence and experience of the internal auditor are important.

The scope of the review must be agreed by members of the authority in consultation with the RFO/Clerk. Where agreement cannot be reached, the authority should determine the scope by resolution. This does not prevent the internal auditor from examining any matter they reasonably consider necessary to provide an independent and objective audit opinion.

During their work, auditors may identify signs of fraud, financial irregularity, misconduct or unlawful activity. Where concerns arise, the internal auditor must report them without delay in line with the authority's reporting procedures. This will normally include reporting the matter to the chair of the council or member of a relevant authority, the Clerk/RFO and, where applicable, the monitoring officer.

Where there is evidence of possible criminal activity, the matter should also be reported to the police.

To reduce the risk of concerns being overlooked or not acted upon, reports should normally be made to more than one appropriate person within the authority. Where necessary, the internal auditor should use alternative reporting routes to ensure the concern is properly considered.

Authorities subject to a limited assurance review should ensure that any such matters are escalated to the external auditor in accordance with the applicable requirements.

4. Internal audit reporting

All internal audit conclusions must be reflected in the annual internal audit report included within the Annual Governance and Accountability Return (AGAR). The report provides an opinion as to whether the authority's control objectives have been achieved throughout the financial year to a standard sufficient to meet the authority's governance, risk management and internal control requirements.

Where any element of the annual internal audit report has not been reviewed or completed, the internal auditor must provide a clear explanation for the omission, including details of when the area was last subject to review and the rationale for any decision not to undertake testing.

Where weaknesses in internal control, governance, risk management or compliance arrangements are identified, the internal auditor will report the associated risks and implications together with recommendations for improvement and any actions considered necessary to address the issues identified.

Any additional audit work commissioned outside the agreed annual internal audit programme must also be formally documented in a separate internal audit report, setting out the scope of work performed, findings and risks identified. This must also be reported to the authority at the earliest opportunity, or alongside the annual internal audit report on the AGAR.

All recommendations arising from internal audit work should be formally reported to the authority. The authority should maintain an action plan setting out the actions to be taken, responsible officers and target implementation dates. Progress against agreed actions should be monitored by the authority and recorded within the minutes of the relevant meeting until all actions have been fully implemented or otherwise closed.

The authority should publish the AGAR, the annual internal audit report, any additional internal audit reports undertaken and any associated action plans on its website in accordance with the requirements applicable to Category 2 authorities in England. Publication should promote transparency and public accountability while taking account of any applicable rights of access legislation.

Before publication or disclosure, the authority must consider its obligations under the UK General Data Protection Regulation (UK GDPR), the Data Protection Act 2018 and any legal, operational, commercial or reputational risks that may arise from the release of information.

5. Support for internal audit

The RFO/Clerk, as well as members, must put in place support for internal audit:

- Support internal audit by giving auditors timely access to the information, records, systems and relevant officers or staff they reasonably need to carry out the audit. Requests from internal audit should be answered within a reasonable timeframe, as delays may affect the effectiveness of the audit.
- Protect the independence of internal audit by ensuring full co-operation throughout the audit process and avoiding any attempt to improperly influence, restrict or direct the auditor's work, findings or conclusions.

- Engage constructively and professionally with internal audit findings, recommendations, opinions and advice, recognising the role of audit in supporting good governance, accountability and continuous improvement.

Members will:

- seek training on internal audit processes so they can understand the purpose and scope of internal audit, consider audit findings effectively and discharge their governance responsibilities
- formally consider and approve the scope of work and annual audit plan proposed by internal audit at an appropriate meeting, to ensure the planned work is appropriate, proportionate and risk based
- ensure that all internal audit reports and associated findings are formally considered and discussed at a meeting of the full council or relevant authority
- monitor progress against internal audit findings, recommendations and agreed actions to ensure they are implemented within an appropriate timeframe. Where actions have not been completed satisfactorily, members should seek further explanation, evidence or assurance from the Clerk/RFO or other responsible officers.

To safeguard the independence and integrity of internal audit, the chair of the authority should provide the internal auditor with direct contact details. This enables confidential reporting of inadequate controls, potential irregularities, governance concerns or poor compliance practices, particularly where the Clerk/RFO may have direct involvement in the matters under review.

6. Responsibilities of the internal auditor

6.1 Before any internal audit work begins, the internal auditor will:

- provide a quotation for the proposed engagement
- identify and disclose any areas where the work required is outside their professional competence; they must not undertake such work unless they have appropriate support or specialist expertise
- demonstrate and evidence their independence annually through a declaration of interest – any relevant changes in circumstances must be disclosed, documented and provided to the authority before appointment
- provide documented evidence of any qualifications, experience or competencies required to undertake the role, where requested
- confirm that they have read, understood and will comply with the requirements set out in the Proper Practices Code for Category 2 Authorities in England
- prepare a formal scoping document setting out the work to be undertaken and submit it to members for approval before starting any internal audit work
- seek appropriate professional advice or guidance where there is uncertainty about the audit methodology or approach. This should be done before the review begins to ensure the work complies with this Code of Practice.

6.2 Throughout the internal audit engagement, all internal auditors will:

- communicate issues identified during the audit to the relevant officers and members in a timely manner so remedial action can be taken promptly; all findings must also be included in the final audit report, even where they have subsequently been resolved
- if internal auditors identify concerns as part of the review, follow the instructions detailed within Section 3 Risk-based audit.

6.3 Upon completion, the internal auditor will:

- provide the annual internal audit report as part of the AGAR, completed in line with the work undertaken; the internal auditor should also provide further information where internal control objectives were not met or were not covered
- produce clear written documentation setting out the work undertaken, the evidence reviewed, including sample sizes where relevant, and any findings identified during the engagement
- where required, attend a full council or relevant authority meeting to present and explain audit findings. Where attendance is not included in the original quotation, a reasonable additional charge may apply. Where attendance is not possible, internal audit must provide enough written information to enable members to understand the findings and recommendations
- ensure that all audit findings are reported to the Clerk and formally presented to full council or relevant authority. This supports transparency and prevents one individual from holding sole awareness of the audit outcomes.

7. Conformance with this Code of Practice

As part of the external auditor's limited assurance review, the following checks may be undertaken for all non-exempt authorities with annual income or expenditure exceeding £200,000, together with a 5% sample of all other non-exempt authorities:

- Review of the minutes of the meeting at which the current internal auditor was first appointed, to confirm that the authority considered and was satisfied with the auditor's independence.
- Review of the detailed internal audit report(s), irrespective of whether any issues or recommendations were raised, together with evidence demonstrating that any recommendations have been appropriately addressed.

Where a new internal auditor has been appointed, the external auditor may also verify that the authority assessed, and satisfied itself regarding, the competence of the internal auditor at the time of appointment.

Any authority that is exempt from the external auditor's limited assurance review must publish its internal audit documentation online in accordance with this Code of Practice. This enables the public to assess whether the authority has conformed to the Code.