the managed audit
2002 update
audit commission
About this leaflet

The Audit Commission (‘the Commission’) has produced this leaflet for all those interested in knowing more about the Managed Audit. It describes:

• What is the Managed Audit?
• Managed Audit and the Code of Audit Practice;
• The right conditions for Managed Audit;
• Benefits of a Managed Audit; and
• Characteristics of a Managed Audit.

The leaflet also includes an annex that updates It Takes Two, the Commission publication that examined the internal/external audit relationship that is so important to the success of Managed Audit.

What is the Managed Audit?

The Commission first published The Managed Audit in 1995. It set out an audit approach to the audit of the accounts that can improve efficiency and produce real benefits for all concerned. It could be applied where the audited body was able to demonstrate:

• sound financial systems;
• effective budgetary controls;
• a reliable accounts production process; and
• good internal audit.

The approach also required the auditor to work closely and effectively with the audited body, and to promote the concept of Managed Audit with officers and other interested parties.

The Managed Audit involved the auditor and the audited body working together, communicating openly, and co-operating to the maximum degree possible without their respective independence and integrity being affected. The relationship between the auditor and audited body must be built on mutual respect and a regard for professional standards of behaviour and work. The approach also required a good understanding of each other’s duties and objectives.

Following a fundamental review, the Commission believes that these principles remain valid and the Managed Audit should now be extended beyond the audit of the accounts to all aspects of the audit under the Code of Audit Practice. Indeed this has already happened at some audits. However, for this to happen more widely, there needs to be high quality input from both the auditor and the audited body across the whole audit.

The Commission encourages all audited bodies and auditors to consider whether they can apply the Managed Audit principles to all aspects of the audit, and to review what action is needed to address areas where that is currently not possible.
Managed Audit and the Code of Audit Practice

The Commission’s new Code of Audit Practice (the Code) was approved by Parliament in March 2000 and applies to audits for 2000/2001 onwards.

The Commission also published the Statement of Responsibilities of Auditors and of Audited Bodies which highlights the different responsibilities of the auditor and the audited body, and the limits on what the auditor can reasonably be expected to do.

The Code has been developed on the basis of the Commission’s model of public audit, which defines auditors’ responsibilities in relation to:

- the financial aspects of corporate governance;
- the accounts; and
- aspects of performance management.

The model reflects the Commission’s concept of an ‘integrated audit’, in which work in relation to one element of the audit informs audit work in relation to other elements. Central to auditors’ work in relation to each of these audit responsibilities is a risk-based approach to audit planning, which reflects their overall assessment of the relevant risks that apply to the audited body and of its corporate governance arrangements.

The new model can be shown diagrammatically as below [EXHIBIT 1].

Where the Managed Audit has been operating successfully, the working partnership established between the auditor and the audited body should be an excellent starting point for implementing the new Code audit.
The Managed Audit can only work completely where the audited body is fulfilling its responsibilities as set out in the Code, and can demonstrate to the auditor how well it is discharging these responsibilities.

The increased focus on governance and risk management in the public sector should leave audited bodies better placed to meet the right conditions for the Managed Audit. However, the Commission recognises that there are different conditions at different audited bodies, and the Code requires the auditor to tailor the audit to local circumstances. It may not be possible, therefore, to apply the principles of the Managed Audit in full at each audited body. However, it should be possible to apply the approach to some aspects of the audit and, over a period of time, to work towards extending this approach to all of it. It is essential that you discuss your position with your auditors to establish what needs to be addressed. As a consequence, it is not possible for the Commission to be specific about what you need to do at your own organisation to achieve the necessary conditions, but some of the potential areas that might need to be addressed are set out below.

**Key conditions for the audited body to address**

- A governance structure that recognises the importance of the financial reporting and audit function (e.g., through an effective, empowered Audit Committee).
- Risk-based planning of resources and effective risk management strategies.
- Clarity of officers’ roles and responsibilities.
- Establishment and maintenance of a strong control environment and good internal controls.
- Staff of the right calibre and expertise, whose skills are maintained by a training strategy that is delivered in practice and ensures that the capability and knowledge of staff matches their responsibilities.
- The appointment of appropriate contact points who co-ordinate effectively the audited body’s communication with the auditor on significant aspects of the external auditor’s work – for example, the timely completion of the accounts and of grant claims and returns.
- Documentation of procedures and processes and adherence in practice to those processes.
- An adequately resourced internal audit function that fulfils its professional and statutory duties with regard to internal control.
- A track record of delivery (e.g., producing final accounts/PIs/grant returns on time) that enables the auditor to plan to rely on the conditions above being met in the future.
Where the necessary conditions are in place, auditors can achieve their responsibilities under the Code in an efficient manner as possible. The auditor can do this by:

- communicating clearly what is needed from the audited body’s staff, and by being flexible in approach;
- using the work of the audited body wherever possible when discharging audit responsibilities;
- working with management to help achieve the key conditions outlined above;
- making appropriate use of the work of, and co-operating with, internal audit and other internal review functions;
- making appropriate use of the audited body’s working papers; and
- improving project management of the audit process.

It is important that the conditions that enable the principles of the Managed Audit to be applied are kept under constant review. Factors affecting both the audited body and the auditor such as a change of key personnel, new duties or new legislation can change the quality of the processes and relationships that underpin the Managed Audit. An open dialogue can help to alleviate potential problems that might stand in the way of the continuing application of the Managed Audit.
The Commission believes that achieving the conditions for the Managed Audit across all aspects of the audit will result in you being well placed to best meet your stewardship and governance responsibilities. Both you and your auditors will be able to work more efficiently and effectively as a result. The benefits available to you of achieving the necessary conditions include:

- a high quality control environment, enabling you to have greater confidence in the information you generate about your performance, and your decision-making process;
- improved arrangements for assessing risk, to inform the decisions about the allocation of scarce resources to the areas of most need;
- an audit that makes the most of the flexibility of the new Code. Because of your arrangements your auditor will be more easily able to target resources at the areas of maximum audit risk, minimising inefficiency and maximising the positive impact of the audit;
- avoiding unnecessary effort. For example, audited body staff understand the auditor’s requirements, and so the standard of evidence provided allows the auditor to minimise demands on officer time; and
- an opportunity to achieve early resolution of potential conflicts and disagreements with your auditor. The open and clear communication that is fundamental to the Managed Audit enables difficult issues to be discussed as soon as they arise – although care must be taken on occasions not to prejudice the need for taking formal advice from relevant experts. This is particularly relevant to the auditor’s responsibilities regarding your arrangements to ensure the legality of transactions that might have significant financial consequences.

Audit Fees

The original Managed Audit publication explained that it is not possible to predict the effect that Managed Audit will have on your audit fee, and this remains the case. Your audit fee is mainly driven by the operational and financial risks that you face which are relevant to the auditor’s duties, and the auditor’s assessment of the arrangements you have in place to deal with those risks. The Managed Audit promotes audit efficiency by encouraging audited bodies to develop more efficient management practices and to communicate those practices clearly to the auditor. A well-controlled audited body that is able to identify its risks and deal with them in an appropriate manner, and which can demonstrate this to the auditor, is entitled to expect the audit to be highly relevant and useful. The audit fee will reflect the work the auditor considers is necessary to discharge his/her statutory and professional responsibilities and the appropriate level of input from different grades of auditor.
Characteristics of a Managed Audit

In summary, the key characteristics of the Managed Audit are:

**Audited body**
- governance arrangements that result in clear strategic goals being set, based on a well-informed, risk-based analysis of the challenges and opportunities facing the organisation, backed by high quality control systems and appropriate monitoring;
- full acceptance and delivery of responsibilities as set out in the Code, and clear documentation of how those responsibilities are being achieved;
- a commitment to work with the auditor to achieve an efficient partnership;
- a clear understanding of the auditor’s responsibilities resulting from ongoing communication; and
- achieving agreed deadlines – and where that is not possible, giving maximum possible notice of any delays.

**Auditor**
- an in-depth understanding of the corporate governance arrangements of the audited body;
- comprehensive risk-based planning to meet the responsibilities of the Code;
- appropriate allocation of audit staff to the wide range of audit tasks;
- an ability and willingness to communicate effectively across all parts of the organisation; and
- a willingness to adapt the audit approach in order to respond to the audited body’s own distinctive systems.
A successful relationship between internal and external audit is a vital part of the Managed Audit. This annex sets out the key conditions for achieving the necessary relationship, and so updates the 1996 Commission leaflet – *It Takes Two*. It is applicable to any model of internal audit that an organisation may employ. The Commission expects its auditors to show the necessary commitment to the messages within the annex, and encourages audited bodies to do the same. The annex focuses on:

- creating the right framework for co-operation;
- what needs to happen in practice;
- potential areas for co-operation;
- the benefits available; and
- the key actions needed.

**Creating the Right Framework for Co-operation**

Internal and external audit need an appropriate framework to deliver their combined contribution to the Managed Audit. External auditors are required to comply with the Code, and as part of their general approach to the audit, to ‘establish effective co-ordination arrangements with internal audit’. They are also required by the Auditing Practices Board Statement of Auditing Standard (SAS) 500 to review the work of internal audit as part of their opinion audit, with a view to using the work of internal audit to help them meet their responsibilities. Internal audit is expected to comply with the appropriate professional standards, such as the National Health Service Internal Audit Manual/Government Internal Audit Manual, CIPFA’s *Code of Practice for internal audit in Local Government*, or Institute of Internal Auditors standards.

But the Managed Audit goes beyond such formal requirements. It is based on the willingness and ability of all involved to co-operate and communicate openly for mutual benefit, building on the conditions highlighted in the main body of this leaflet. Specifically for internal and external audit, the key factors are:

- audited body commitment;
- understanding each other’s roles; and
- partnership working.

**Audited body commitment**

In order for internal audit to be able to participate fully in the Managed Audit, it needs sufficient backing to enable it to achieve its own objectives. The audited body needs to specify internal audit’s role, and to review achievement against it. Some of the key actions for the audited body to address are set out below.
## Key actions for the audited body to take in respect of internal audit

| **Resources** | Internal audit needs appropriate resources to carry out its statutory and professional responsibilities. The Turnbull Committee\(^1\) recognised that internal audit has a major role to play in securing the right internal control environment, and that message applies equally in the public sector. |
| **Status** | Appropriate status is a key to attracting the high quality staff needed to deliver the complex remit given to many internal audit sections, or to attract external providers with the right skills and commitment. Internal audit is a key element in the arrangements to provide assurance on the internal control framework, and failure to implement the recommendations of internal audit should be a serious matter. |
| **Reporting Lines** | Internal audit needs clear, unfettered reporting lines to those charged with corporate governance, and the right to report to anyone it considers appropriate. Typically such rights are included in an internal audit charter. NHS bodies have an audit committee, which provides an ideal vehicle for internal audit’s voice to be heard. In local government, new governance structures may mean that the audit committee’s (or its equivalent) tasks are split between the executive and the scrutiny functions, potentially diluting audit’s focus and impact – care must be taken to ensure that internal audit does not become sidelined. |

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Understanding each other’s roles

Internal and external audit need to have a thorough understanding of each other’s roles and approach to achieving their respective objectives, including their statutory and professional responsibilities. Internal audit’s role also varies considerably between organisations due to local circumstances, particularly in local government. Until the similarities and differences in the objectives of internal and external audit are identified and understood, the relationship cannot develop fully. Each must also respond effectively to changes in the modern audit world – for example, it is expected that internal audit will have a significant role in relation to the Statement of Internal Control given by the Boards of NHS bodies.

Proactive partnership

Both sides need to commit to an open and two-way relationship, respecting each other’s primary need to fulfil their own remit and to maximise the impact of the total audit resource, whilst looking for ways to work that avoid duplication or wasted effort. In the past, there has been a tendency for external audit to dominate the relationship as it is more common for it to use internal audit’s work than vice versa, but both sides must be prepared to contribute actively rather than reactively if it is to be an effective partnership.

What Needs to Happen in Practice

There are a number of factors that are essential to helping internal and external audit get the most out of working together.

Communication

Internal and external audit must establish clear and open lines of communication that produce two-way dialogue and meaningful discussion. In addition to regular meetings, each side should inform the other as soon as possible of any matter that might impact on the audit work planned.

Of particular importance is the need to provide full and frank feedback – for example after a joint project, or following external audit’s review of internal audit’s work. This includes reporting, where appropriate, to the audit committee or equivalent in order to engage those with governance responsibilities.

Quality of work

Both sides need to maintain a consistently high quality of work, enabling each to plan with confidence to use the projects in each other’s plans. Addressing training needs,
giving proper supervision and ensuring work is subject to prompt review, all help to achieve this. Increasingly auditors are making use of the review of all or part of their work by peers or by specialist teams within their own organisations, and this can help to build confidence.

The audited body should examine the different models of internal audit delivery. The use of consortia in the NHS has improved performance standards, and external provision of some or all aspects of local government internal audit is becoming more common. These options can help to overcome the problems faced by small audit teams by offering a wider skill base, and can also address shortages in specialist skills such as IT.

**Sharing risk-based assessments**

Audit effort should be directed towards the areas of highest risk, assessed in relation to the relevant objectives and responsibilities of internal and external audit. The different remits of internal and external audit mean that they will need to perform their own risk assessments, but comparing the results should mean that both benefit from the different perspective, and helps build the knowledge base of both sides.

Both audit teams should produce their own plans based on risk, taking into account their respective objectives and the intentions of the other wherever possible. Internal audit plans for a particular financial year are commonly prepared several months in advance of external audit’s plans because of timing differences in the audit year. However risk assessment is an ongoing discipline and so comparing results should not be a problem as they should be ‘live’ throughout the year. The plans may initially overlap, and to avoid duplication there needs to be a discussion on the detailed requirements and agreement on a way forward. The overall picture, suitably co-ordinated, can then be presented to the audited body to demonstrate the intended audit coverage.

The Commission considers that the audited body should only direct internal audit resource away from its risk-based plan following a detailed assessment of the impact of doing so. One common instance where audited bodies direct internal audit is when they try to avoid incurring what are perceived to be additional external audit costs, but this can be at the expense of a higher risk piece of work that internal audit has to drop from its programme.

**Documentation and evidencing work done**

External audit’s work should meet the necessary standard of documentation and evidencing. The Audit Commission’s guidance for auditors requires that ‘Audit records should be sufficiently complete and detailed to provide an experienced auditor, with no previous connection with the audit, with an understanding of the work performed and the basis of the decisions taken’. The Commission considers that internal audit should meet similar standards.
Sharing files

External audit must satisfy itself that internal audit’s work is appropriate to use, and reviewing relevant files is an essential step in the process. Should internal audit request access to external audit files (for example, as part of a joint project), care will be needed to comply with the statutory restrictions on disclosure of information by external auditors, and each case needs to be considered individually.

‘No surprises’ reporting

It makes sense for each audit team to be aware in advance of the main messages in each other’s reports. This avoids conflicting messages, and also acts as a useful additional check on the factual content of reports. It may also be beneficial to adopt similar styles of reporting and presentation to avoid confusion.

Potential Areas for Co-operation

The extent of internal and external audit co-operation will vary according to the remit given to internal audit, but potentially common areas of Code\(^1\) work are listed opposite.

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\(^1\) In addition to work under the Code, auditors carry out work on specific grants and returns in accordance with instructions agreed by the Commission with the grant-paying body. The Commission specifies that ‘appropriate use should be made of internal audit work’ (including an element of re-performance) when auditors carry out their work on grants, so there is also scope here for co-operation.

<table>
<thead>
<tr>
<th>Code area</th>
<th>Potential internal audit work that external audit could use</th>
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| **Opinion** | Checks on year-end returns (e.g., from departments) to ensure compliance with standards and procedures  
Internal financial control work may be used for opinion purposes when applying SAS 300 ‘Accounting and Internal Control Systems and Audit Risk Assessments’ to significant financial statement items |
| **Use of resources** | Application of use of resources reviews (generated by the Commission, the external auditor or internal audit)  
Follow-up of previous recommendations |
| **Performance information** | Detailed work to check systems of compilation and calculation |
| **Best Value Performance Plans** | Various potential roles identified in *An Inside Job*II |
| **Legality of financial transactions** | Review of procedures to ensure legality of significant transactions |
| **Financial standing** | Review of internal financial control, specifically robustness of short, medium and long-term budgetary procedures |
| **Systems of internal financial control** | Review of financial systems leading to conclusion on internal financial control |
| **Standards of financial conduct, and the prevention and detection of fraud and corruption** | Review of procedures in place  
Investigatory role and dealing with whistleblowing |
Practical examples of the ways in which internal and external audit co-operate are set out below [CASE STUDIES 1 AND 2].

CASE STUDY 1
External and Internal Audit Joint Arrangements – Local Government

At a large council, both internal and external audit embraced the Managed Audit from its inception. They discussed where their responsibilities overlapped – which was in all areas of their work – and developed joint planning arrangements at a strategic level (covering three years) and annual detailed plans. Agreement was reached on common methodologies, documentation, and monitoring and review mechanisms – including the extent of external audit use of internal audit’s work.

Benefits from the application of the Managed Audit included avoiding duplication and omission in the joint plans and joint working on corporate governance, best value, use of resources reviews and IT audit, thus enabling a sharing of scarce resources. The client has obtained a better understanding of both audit roles which has been further enhanced by joint presentations, and audit now has a greater profile within the Council. The arrangements also led to a reduction of external audit fees.

CASE STUDY 2
External and Internal Audit Joint Arrangements – NHS

The internal and external auditors of a large health community (a Health Authority and a number of Primary Care Trusts) have enthusiastically adopted the principles of It Takes Two and the Managed Audit to the benefit of all concerned.

The audit approach was planned on the basis of the health community as a whole, rather than as a series of individual bodies, requiring close co-operation between the internal and external auditors. They worked openly and proactively to ensure that the timing and content of their respective audit plans were ‘joined up’. Internal audit also agreed to adapt its approach and to refocus its testing to enable greater use by external audit of its work, whilst at the same time ensuring it did not compromise the achievement of its own objectives. Joint presentations to audit committees have helped to ease concerns about duplication of effort (particularly amongst the newly formed bodies), and have presented a positive picture of the audit process.

As a result of the joint approach, there is a more efficient and effective use of the total audit resource. Both audit teams have gained a greater understanding of the other’s responsibilities. The co-operation between them has enabled them to communicate better with the health community, to understand better the business risks faced by it, and they are better placed to deliver an audit service that will make a real difference.
The Benefits Available

Where internal and external audit work closer together under Managed Audit, benefits should accrue to all concerned.

<table>
<thead>
<tr>
<th>Internal Audit</th>
<th>Audited Body</th>
<th>External Audit</th>
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</thead>
<tbody>
<tr>
<td>Increased credibility and presence with management and members</td>
<td>Clearer, more consistent reporting of audit issues</td>
<td>Better understanding of the corporate framework</td>
</tr>
<tr>
<td>Greater emphasis on internal audit’s own objectives</td>
<td>Much reduced chance of duplication or omission of audit work</td>
<td>Results in an audit more tailored and relevant to the audited body</td>
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<tr>
<td>Greater awareness of risk from an external observer’s perspective</td>
<td>Better focused audit work that provides more relevant information</td>
<td>Increased awareness of risk factors at the audited body</td>
</tr>
<tr>
<td>Opportunity for cross-training eg, IT auditing</td>
<td>Maximises the positive impact of audit</td>
<td>More efficient audit approach</td>
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The Key Actions Needed

In summary, there are a number of key actions for management, internal and external audit to take if they are to make the most of the opportunities offered by integrating the work of the audit functions.

<table>
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<tr>
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<th>External Audit</th>
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<tbody>
<tr>
<td>Understand external audit’s role and objectives</td>
<td>Ensure internal audit’s role is clear, and that it has sufficient resources to achieve its objectives</td>
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</tr>
<tr>
<td>Plan to meet statutory and professional objectives, and review planned work programme with external audit to avoid duplication</td>
<td>Look at the options for internal audit provision to ensure the highest quality is being achieved</td>
<td>Plan to meet Code objectives, making use of internal audit’s work wherever possible</td>
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<tr>
<td>Report without fear or favour to the appropriate person/committee, and co-ordinate timing and content of reports with external audit</td>
<td>Provide internal audit with appropriate reporting lines within the governance structure</td>
<td>Share reporting intentions with internal audit, and co-ordinate timing and content</td>
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<tr>
<td>Participate proactively in the partnership</td>
<td>Ensure that internal audit’s independence is not compromised, and that it is not required to carry out non-audit work</td>
<td>Enter into a real partnership – for example, do not seek to ‘instruct’ internal audit or to create a ‘one-way’ relationship</td>
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<tr>
<td>Plan work on a risk basis to ensure that the highest priority work is delivered to ensure credibility</td>
<td>Provide internal audit with the necessary status</td>
<td>Provide feedback to help ensure continuing improvement</td>
</tr>
<tr>
<td>Adopt a ‘no surprises’ approach to reporting by ensuring that each party is aware of issues to be raised</td>
<td>Critically review the achievement of co-operation between the audit functions</td>
<td>Adopt a ‘no surprises’ approach to reporting by ensuring that each party is aware of issues to be raised</td>
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